PRELIMINARY FEASIBILITY
For Purposes of Internal Discussion

CONFIDENTIAL

SOUTH STATION HEADHOUSE AND CONCOURSE

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SOUTH STATION HEADHOUSE AND CONCOURSE PRELIMINARY FEASIBILITY

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I. INTRODUCTION

This preliminary feasibility deals with the following at the South Station Terminal Complex:

1. <u>The South Station Headhouse</u> - A 118,000 square foot building on five levels (25,000 sq. ft. on every level except level 2 which has 18,000 sq. ft.). The headhouse is on the National Register of Historic Buildings.

2. <u>The South Station Concourse</u> - An area of 37,000 square feet on one level. This area now functions as a waiting room and passageway to trains and buses, and a retail area.

III. CONCLUSIONS

1. The Breakeven average annual rent per square foot for each of the three total development cost levels (assuming 102,420 effectively rentable square feet, 75,097 office, and 27,323 retail) is as follows:

	Total Development Cost	Break Even Average Annual Rental
Level #1	$2.7 million	$4.49
Level #2	$6.5 million	$6.36
Level #3	$9.5 million	$9.57

The assumptions built into these numbers are detailed in Table #1.

2. The overall office vacancy rate in Boston as reported by the Ryan Elliott Survey is 14.8% and as reported by the BOMA Survey it is 11.5%.

3. These two office surveys, Ryan Elliott and BOMA show a greater vacancy rate in the lesser quality, cheaper space than in the more expensive first class space. For instance, Ryan Elliott shows a vacancy rate of 11.5, 12.2, and 21.2 in Class A, B, and C respectively.

4. South Station as an office and retail complex is unique and not directly related to the overall office - retail space market, i.e. it is not a commodity as glass office

towers tend to be. Stated differently, it is important to focus on the "market segment" which might be interested in locating in South Station.

5. At this point in the feasibility process, a final assessment has not been made as to whether or not there is a market for the South Station space at the various per square foot break even points.

There is, however, some information which is helpful in assessing this question that is contained in the market analysis sections of this report, Sections VI and VII.

6. The success of a South Station redevelopment at <u>any development cost option</u> comes down to finding out if there are 102,000 square feet of users who are ready to sign leases. Users who, in effect, are willing to pay for being there as opposed to being

(1) in a glass tower near South Station

(2) in an older building near South Station

(3) in a "special aura" recycled building such as Old City Hall, 1 Winthrop Square, or Faneuil Hall.

7. The office user survey data seems to say that the chance of finding a market for the South Station office space is greater with the highest quality option. This is so because overall vacancy rates are lower in first class buildings than in 2nd and 3rd class buildings.

8. If the $9.5 million option is chosen, the result could be the transformation of South Station into:

(1) A public meeting place for all the citizens of Boston which will enhance the financial district, the Fort Point Channel area, and the Lafayette Place shopping area.

(2) A Class A office building.

(3) A Transportation Center which people feel good about using.

(4) The Concourse can be the public meeting place for people who work in office buildings, for artists, for new residents who will occupy the recycled downtown buildings and for people who visit.

At the concourse one can linger over a cup of espresso coffee and a croissant with an old friend, greet relatives arriving by train, have a sauna and massage as a way to relax, and eat some fresh seafood brought in from the harbor that morning.

What we will have in the Concourse is the following:

a. Comfortable, canopied seating areas in the middle of the Concourse totalling 7,237 square feet.

b. A glass wall along the entire north end of the building which will enable everyone to view the comings and goings of the people, the trains, and the buses.

c. Bright cheerful lighting.

d. Year round temperature control.

e. A new roof.

f. Bright, colorful, cheerful decor.

IV. RECOMMENDATIONS

A. The feasibility analysis process should include the process of talking to potential tenants with a prepared lease committment ready for signature.

B. The process of obtaining leases should be conducted with top quality renderings and a model of the recycled space.

C. Careful consideration should be given to these elements which will contribute to putting South Station in the "special aura" class.

For instance, the Park in front of One Winthrop Square is a major factor in its success.

D. A beautifully designed concourse and a pedestrian walkway over the expressway could do for South Station and the entire financial district and Fort Point Channel area what the Waterfront Park has done for the Waterfront Area.

E. A meeting could be held with Mr. Marsom Pratt of Adams, Harkness, and Hill, investment bankers, who is interested in a meeting to discuss the possibility of his firm financing the project. He wants to bring a representative from Goldman Sachs, a large New York investment banking firm, to the meeting.

F. The final feasibility, should give more attention to the financial-legal-organizational structure of the proposed development, especially the tax shelter equity investment portion. The aim in the financial legal structure is to achieve the best of both the public purpose development world and the private business development world. In this regard, please see Tax-Exempt Financing of Community Controlled Cable Television Facilities by James Perkins of Palmer and Dodge, How A Brilliant Restauranteur Created A Masterpiece On The 107th Floor of the World Trade Center, New York Magazine 5/31/76, and Limited Dividend Approach To For-Profit Housing - Considerations In Packaging A Product by Melvin Epstein in the Appendix to this report.

V. COSTS AND FEASIBILITY

A. Construction Rehabilitation Costs

The costs for the Headhouse in Table I are based on estimates made by Parsons, Brinckerhoff, Quade, and Douglas. The costs for the concourse are based on estimates made by Robert Kroin of the BRA. In each case 40% was added for contingency, overhead, and profit.

B. Project Development Costs

Based on the Construction Rehabilitation Costs in Section A Total Project Development Costs were arrived at by including cost items incurred by the developer in addition to the construction rehabilitation costs.

Three Total Development Cost Options are outlined as follows:

Option #1	$2.7 million	Bringing South Station Headhouse up to level of Boston Building Code and Rehabilitation of Concourse.
Option #2	$6.5 million	Complete 1st class rehabilitation except interior renovation of floors 3, 4, and 5 and Rehabilitation of the Concourse.
Option #3	$9.5 million	Complete 1st class rehabilitation of Headhouse and Rehabilitation of Concourse.

C. Operating Expenses

Annual operating cost estimates per square foot exclusive of taxes were obtained from owners and managers of analagous buildings and from projections for railroad terminal recycling in New London and Providence. These costs include all building services such as heating and cooling the entire building, but do not include electricity costs within tenants offices for lighting and for operating office machines.[1] These are listed in Table 2.

There is a wide range of operating cost estimates. This calls for more detailed study in the next stage of analysis. At this stage we are using the highest figure $2.40 per square foot per year.

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1. The New London Station is an exception in that there is a system at New London which passes on to the tenant in their electricity bill some of the costs of heating and cooling their offices.

Table 2

SELECTED OFFICE BUILDING ANNUAL OPERATING COSTS
PER SQUARE FOOT EXCLUSIVE OF TAXES

Providence Rail Station (projected)	1.13
New London Rail Station (projected)	1.67
Ryan Elliot Estimate (Dan Woolley)	1.80
Boston Old City Hall	2.00
One Winthrop Square	2.40

D. Rental Income

Rental Income is derived for the three development cost options using $10, $7, and $5 for the office space and $9 for the retail space. A 5% vacancy factor and an 85% office square foot utilization factor are used to arrive at Effective Gross Income.

Subtracted from Effective Gross Income are the following annual cash expenses to arrive at Total Annual Net Operating Income Available for Debt Service:

1. Operating Expenses
2. Investor Annual Dividend
3. Payment In Lieu of City Taxes

E. Financing

For each development cost option, a mortgage amount is derived in line #5 by subtracting project grants from total project development costs. Using a 25 year 9% mortgage, total annual cash requirements for debt service is presented in line #6.

Line #6 of Section E should be compared to the last line in Section D, Total Annual Net Operating Income Available for Debt Service to determine feasibility.

For instance, under option #2, cash requirement for debt service is $139,150 (Section E, line #6) and Total Annual Net Operating Income Available for Debt Service is $336,236 (Section D, last line).

Section E, line 10 presents total annual carrying costs, i. e. All annual cash costs, and includes the following:

1. Annual Debt Service
2. Annual Operating Costs exclusive of taxes
3. Annual Cash Dividend to Investors
4. Annual In Lieu Tax Payment

Total Annual Carrying Costs can be compared to Effective Gross Income for Section D to determine whether cash coming in each year is more or less than cash going out.

A break even rental per square foot is calculated in line #12 of Section F by dividing 102, 420 square feet into Section F, line #10, Total Annual Carrying Costs.

Table 1

SOUTH STATION HEADHOUSE
COSTS AND FEASIBILITY

A. Construction Rehabilitation Costs

I. Minimum renovation to bring up to code standards			1,665,860
A. Architectural			
1. demolition		63,000	
2. concrete steel tower		48,800	
3. steel for 2nd flr. stair		7,500	
4. steel for replacing open stair		13,000	
5. fireproofing for steel		18,000	
6. gutter and downspouts		40,000	
7. second floor windows		26,800	
8. second floor interior (relocation)		115,800	
9. elevators in existing shafts		45,000	
		337,900	
Contingency overhead & profit (40%)		135,160	
	Sub-total	473,060	
B. Plumbing		502,000	
Fire Protection		350,000	
		852,000	
Contingency overhead & profit (40%)		340,800	
	Sub-total	1,192,800	
Total I and Concourse		2,083,660	

SOUTH STATION

A. Construction Rehabilitation Costs

II. Air Conditioning		2,424,800
A. Air conditioning	1,240,000	
steel for cooling tower	25,000	
B. Electrical system	467,000	
	1,732,000	
Contingency overhead & profit (40%)	692,800	
Total I and II		$4,090,660
III. New elevators, new roof, exterior cleaning, Complete 2nd flr. renovation		746,130
A. Four new elevators	250,000	
concrete structure for elevators	64,800	
B. New roof	118,700	
C. Exterior cleaning	31,200	
D. Complete 2nd flr. renovation	68,250	
	532,950	
Contingency overhead and profit	213,180	
	746,130	
Total I and II and III		$4,836,790
Total I and II and III and Concourse		5,254,590

SOUTH STATION

A. Construction Rehabilitation Costs

IV.	Interior renovation flrs. 3-4-5 And Concourse renovation		2,400,500
A.	Interior renovation flrs. 3-5	$1,714,900	
	Contingency and profit (40%)	685,600	
		2,400,500	
B.	Concourse	297,000	
	Contingency overhead and profit (40%)	118,800	
		417,800	
	Total I and II and III and IV (Concourse included in IV)		7,655,090

SOUTH STATION

B. Project Development Costs	Development Cost Options 1	2	3
1. total construction rehabilitation	$7,655,090	5,254,590	2,083,660
2. architectural & Engineering Consulting (10%)	765,509	525,459	208,366
3. legal fees	75,000	75,000	75,000
4. expenses during construction interest (10% const. loan over 2 yrs. 45% avg. outstanding balance or $3,444,791 - 2,364,565 - 937,647)	688,958	472,913	187,529
5. insurance	20,000	20,000	20,000
6. leasing promotion	78,000	78,000	30,000
7. leasing fees	180,000	100,000	71,000
TOTAL PROJECT DEVELOPMENT COSTS	9,462,557	6,488,360	2,675,555

SOUTH STATION HEADHOUSE AND CONCOURSE

C. Annual Operating Expenses

Headhouse	118,000			
Concourse	37,000			
	155,000	sq.ft.	155,000	155,000
Operating Costs per sq. ft.	$ 2.40		$ 2.00	$ 1.80
ANNUAL TOTAL OPERATING EXPENSES EXCLUSIVE OF TAXES	$372,000		$310,000	$279,000

Development Cost Option	3	2	1
Office Rent Per Square Foot	$ 10	$ 7	$ 5
D. <u>Rental Income</u>			
1. flrs. 2-5 93,000 sq.ft. 85% utilization = 79,050 sq.ft.	790,500	553,350	395,250
2. waiting room 1st floor 6,600 sq.ft. @ $9	59,400	59,400	59,400
3. retail space 1st flr. 8,287 sq.ft. @ $9	74,583	74,583	74,583
4. retail space concourse 13,874 sq.ft. @ $9	124,866	124,866	124,866
Total anticipated annual gross income	1,049,349	812,199	654,099
Less 5% vacancy	52,467	40,610	32,705
Effective gross income	996,881	771,589	621,394
Less operating expenses $2.40/sq.ft. exclusive of taxes	372,000	372,000	372,000
Less investor dividend 10% of amounted invested	92,295	63,353	25,619
Less payment In Lieu of Taxes to City - 10% of effective gross income	100,000	77,000	62,000
TOTAL ANNUAL NET OPERATING INCOME AVAILABLE FOR DEBT SERVICE	432,586	336,236	223,775

E. <u>Financing</u>

		3	2	1
1.	Total project development cost options (Section B)	$9,462,557	$6,488,360	$2,675,555
	<u>Less Grants</u>			
	Intermodal Grant - FRA			
	EDA Title X	1,000,000	1,000,000	1,000,000
	HUD - Historic Bldgs. Program			
	Dept. of Interior			
	National Park Service - Historic Preservation	107,900	107,900	107,900
	National Trust for Historic Preservation			
	State			
	Amtrak Improvement Act.			
2.	Net project cost	6,354,657	5,380,460	1,567,655
3.	Investor Equity and Development Fee (Tax Shelter)	922,956[1]	633,536[1]	256,195[1]
4.	Projected Additional Federal Grants	4,000,000	4,000,000	1,567,655
5.	Mortgage amount	4,354,657	1,380,460	0
6.	Total Cash Requirement for Debt Service (25 yr. mortgage @ 9% constant annual carrying costs of 10.08%)	438,949	139,150	0
7.	Total annual operating Costs	372,000	372,000	372,000
8.	Total annual dividend	92,295	63,353	25,619
9.	Total in lieu tax payment	100,000	77,000	62,000
10.	Total Annual Carrying Costs	1,003,244	651,503	459,619
11.	Effective Gross Income (Assumes 5% vacancy)	996,881	771,589	621,394
12.	Break even rental per square foot line #10 ÷ 107,811(.95) = 102,420	9.79	6.36	4.49

1. This investor equity is assumed <u>not</u> to remain in the project, but to go to the developer. More analysis needs to be done to obtain a firmer estimate of this number and best method for structuring the deal.

F. <u>The South Station Concourse</u>

The South Station Concourse is a 37,000 square foot enclosed area which is now used as the passageway to the trains and buses and some retail including a newsstand.

The revitalization of this space is the key to the revitalization of the entire South Station Complex.

The Concourse can be the public meeting place for people who work in office buildings, for artists, for current residents, for new residents who will occupy the recycled downtown buildings and for people who visit.

At the Concourse one can linger over a cup of espresso coffee with an old friend, greet relatives arriving from New York by train, have a sauna and massage as a breakout of a busy work day, or eat some fresh seafood brought in from the harbor that morning.

What we will have in the Concourse is the following:

1. Comfortable, canopied seating areas in the middle of the Concourse totalling 7,237 square feet.

2. A glass wall along the entire north end of the building which will enable everyone to view the comings and goings of the people, the trains, and the buses.

3. Bright, cheerful lighting.

4. Year round temperature control.

5. A new roof.

6. Bright, colorful, cheerful decor.

Construction Rehabilitation Costs

For a total price of $418,000m we can have a Concourse that will draw people from miles around and will be a place in which people feel good. It will be a key link not only for the South Station complex but for the revitalization of the entire lower financial district, Fort Point Channel and the Lafayette Place shopping district.

The cost breakdown is as follows:

New roof	150,000	
Glass wall	37,800	
Canopy	10,000	
Lighting	50,000	
Air Conditioning	50,000	
Total		$297,000

ADD

40% for (1)	Contingency (20%)	
(2)	Profit and Overhead (20%)	$118,800

Total Construction Rehabilitation Cost $417,800

Square Feet of Rental Space

The total rentable retail space which would be created in the Concourse would be:

1.	Canopied seating area	7,237
2.	Southeast wall	4,337
3.	Northeast wall	880
4.	South wall	2,430
		13,874 square feet

VI. BOSTON OFFICE MARKET AS RELATES TO SOUTH STATION HEADHOUSE

The ultimate question which has to be faced about South Station office feasibility (as in all feasibility studies) is whether the space can be rented and at what price?

The following remarks constitute a preliminary assessment with supporting empirical information. The assessment is also based on conversations with the following people:

1. Mr. Dan Woolley, Ryan Elliott - please see his memo in the Appendix.
2. Mr. John Read, Ryan Elliott - rented 1 Winthrop Square currently renting
3. Mr. Tom White, Raymond Cattle Company
4. Ms. Cheryl Markovitz, BOMA - conducted recent office survey.
5. Mr. Ted Raymond, Developer - 1 Winthrop Square
6. Mr. Roger Webb, Developer - Old City Hall

Ryan Elliott and BOMA Survey

The differences between the Ryan Elliott office survey and the BOMA office survey are as follows:

1. RE includes more buildings and more square feet.
2. RE is based partially on the day-to-day experience of renting space. BOMA is based solely on a written questionnaire.
3. RE separates out office space which is really not on the market, i.e. owner occupied space and space which is under long term lease from space which is on the market, i.e. vacant space and occupied space with a ten year or less lease. BOMA does not make this distinction.

Ryan Elliot Survey - Key Facts

The RE survey 1/15/76 contains the following important information:

1. There is 12.0 million square feet of Class A office space in Boston of which 6.1 million square feet is "competitive space", i.e. vacant space and occupied space likely to be available within the next ten years.

2. The vacancy rate for Boston for is 14.8% for total space and for "competive space" it is 22.7 %. A total of 1.4 million square feet of office space is vacant.

3. In the financial district of Boston there is 7.9 million square feet of Class A space and 3.5 million square feet of "competitive space."

4. The vacancy rate for all Class A space in the financial district is 11.4% and 25.6% for competitive space. A total of .9 million square feet of vacant Class A space exists in the financial district.

Projecting the Future

There will be coming on the market in the next two years 875,000 square feet of Class A space which is not yet leased as listed below:

	Square Feet Currently Not Rented
Federal Reserve Building	150,000
60 State Street	500,000
175 Federal	75,000
Faneuil Hall	150,000
Total	875,000

The 875,000 square feet plus 1,350,000 square feet of currently vacant space means that 2,225,000 square feet of Class A space will be available through 1980 in Boston.

Will the 2.25 million Class A space be absorbed?

From 1971 to 1976 .4 million square feet of Class A office space was absorbed annually in Boston (see Woolley Memo). If this .4 million square feet annual absorption continues through 1980, the 2.25 million square feet identified as available or coming available through 1980 will be used. Will this absorption trend continue? Nobody knows for sure. In the past the absorption of Class A space has come from: (1) upgrading and internal growth from Class B and C space,

(2) internal growth of Class A, and (3) office movement from outside Boston.

One way to get a firmer estimate of the potential absorption would be to survey the 1.9 million square feet of Class B and the 7.1 million square feet of Class C "competitive office space" users to determine their potential interest in upgrading to Class A. One would also want to determine if any significant reverse movement will take place, i.e. from Class A to Class B.

One scenario for absorption of the 2.25 million square feet of Class A square identified as available through 1980 is as follows:

1. 4% per year internal growth of the 12 million Class A square feet or 1.9 million square feet over 4 years.

2. Upgrading from Class B - .2 million

3. Movement into Boston - .2 million

Total Office Space Absorption - 2.3 million square feet

Table 4

POTENTIAL SOURCES FOR CLASS A OFFICE SPACE
BOSTON, MASSACHUSETTS
1977 - 1980

A. Growth of Existing A users		
1. 3% per year times 12 million 360,000 per year or 1.4 million in 4 years	=	1.4 million
2. 4% per year = 480,000 x 4	=	1.9 million
3. 5% per year - 600,000 x 4	=	2.4 million
B. Movement from B		.2
C. Movement from outside Boston		.2

VII. MARKET CONSIDERATIONS FOR SOUTH STATION

South Station is one of a kind in the whole City of Boston. An argument could be made that the rentability of South Station's 93,000 square feet of office space is related to the general office market in a very minor way. The argument goes like this:

1. South Station is not a commodity as is the typical Class A glass office tower and therefore does not relate to this market.

2. South Station has to be thought of in terms of the market for recycled unique buildings such as Old City Hall, one Winthrop Square, and Fanueil Hall Market Place.

The questions which have to be asked about the South Station office space are:

1. Are there 93,000 square feet of users who will want to locate in South Station?

2. What price will they be willing to pay?

The way to find out is to have some attractive renderings drawn of the rehabilitated space and use these pictures to sign up tenants before any significant committments are made by the BRA.

We have gathered the following information related to the question of the rentability of South Station:

1. Mr. Drew Hyde of MBTA says that MBTA would rent 65,000 square feet for $6 per square foot for fully renovated space. They would sign a 40 year lease. This assumes they do not move into the Park Plaza transportation center. Mr. Hyde feels he could arrange 80% Federal financing for the full renovation, since he recognizes that $6 would not cover the rehabilitation costs.

2. Mr. John Read of Ryan Elliott has spoken to the users of 2 million square feet in his efforts to rent the 190,000 square feet of available space in the Federal Reserve Building next to South Station. He has leased a total of 50,000 square feet to one tenant.

Mr. Read indicates that there is considerable resistance to the idea of being across the highway from the "main part of town". He hopes this resistance will soften when the Federal Reserve Building is more complete than it is now.

3. Mr. John Read of Ryan Elliott who leased One Winthrop Square and is currently leasing the New Federal Reserve Tower estimates that the market for top quality

recycled space in Boston is 50,000 to 75,000 square feet per year. At the same time, Mr. Read is not sure whether a fully rehabilitated South Station could be made to fit into the category of "a special office rehabilitation" in the eyes of the users of 93,000 square feet. Here again, the implication is that to develop South Station, one should first have a clear identification of, if not firm committments from, tenants who want to locate in South Station.

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Boston Office Edition Real Estate Market Survey January 15, 1976

In our last Boston Office survey, we predicted a rising vacancy rate. This has occurred and the year end office vacancy rate stands at 14.8% . . . the highest we have seen in ten years.

The dramatic increases are clearly visible in all classes of buildings in the Financial District. For this survey, two Class A buildings with a total of 1,946,664 square feet were added. Of that total, 349,000 square feet is vacant. Major vacancy increases also occurred in Class B and C buildings with an increase since our May, 1975 survey of 596,180 square feet. The primary reason for this increase relates to moves made from older to newer buildings by a major Boston employer.

On the positive side, our market is active. Approximately 1.4 million feet of office space was leased in 1975 and we would estimate similar activity in 1976.

Our six month outlook is for a substantial reduction in Class A vacancy rates and a leveling off and slight reduction in Class B and C vacancies. Looking to the end of 1976, we see an overall vacancy rate in the 10% - 12% range.

Districts	Bldg. Class	Number of Bldgs.	Total Office Space (Sq.Ft.)	Non-Competitive Office Space (Sq.Ft.)	Competitive Office Space (Sq.Ft.)	Vacant Office Space (Sq.Ft.) 1/2/76	Percentage Vacant to Competitive Space 5/1/75	Percentage Vacant to Competitive Space 1/1/76	Percent Vacant to Total Office Space 5/1/75	Percent Vacant to Total Office Space 1/1/76
Government	A	13	2,241,771	637,100	1,604,671	326,260	20.8	20.3	14.9	14.6
Center	B	1	31,500	10,000	21,500	–	–	–	–	–
	C	13	1,185,400	184,400	1,001,000	132,939	8.4	13.3	7.1	11.2
	Sub-Total	27	3,458,671	831,500	2,627,171	459,199	15.9	17.5	12.1	13.3
Financial	A	16	7,926,628	4,412,766	3,513,862	900,147	13.0	25.6	6.2	11.4
	B	12	2,576,113	1,510,113	1,066,000	293,419	9.9	27.5	4.1	11.4
	C	72	4,261,290	625,551	3,635,739	862,967	13.4	23.7	11.7	20.1
	Sub-Total	100	14,764,031	6,548,430	8,215,601	2,056,533	12.7	25.0	7.6	13.9
Midtown	A	2	165,562	63,000	102,562	98,000	100.0	95.6	61.9	59.2
	B	2	303,360	–	303,360	136,364	42.4	45.0	42.4	45.0
	C	31	1,839,385	155,180	1,684,205	569,214	30.2	33.8	27.7	31.0
	Sub-Total	35	2,308,307	218,180	2,090,127	803,578	35.4	38.5	32.1	34.8
Back Bay	A	5	1,711,600	828,800	882,800	63, 376	4.4	7.2	2.3	3.7
	B	7	1,968,500	1,409,000	559,500	167,152	21.1	29.9	6.0	8.5
	C	21	889,746	96,600	793,146	168,459	21.9	21.2	19.5	18.9
	Sub-Total	33	4,569,846	2,334,400	2,235,446	398,987	14.8	17.9	7.3	8.7
District	A	36	12,045,561	5,941,666	6,103,895	1,387,783	15.5	22.7	8.4	11.5
Totals	B	22	4,879,473	2,929,113	1,950,360	596,935	18.1	30.6	7.2	12.2
	C	137	8,175,821	1,061,731	7,114,090	1,733,579	17.7	24.4	15.6	21.2
	Total	195	25,100,855	9,932,510	15,168,345	3,718,297	16.9	24.5	10.7	14.8

Notes

Buildings Included in Survey are Qualified as Follows:
A. A readily identifiable office environment.
B. Occupied buildings or buildings ready for occupancy by January 2, 1976.
C. Buildings within the following perimeter: Boston as bounded by the harbor, the Charles River, Massachusetts Avenue, Columbus Avenue, Massachusetts Turnpike Extension, and Fort Point Channel.

Building Classification:
A, B and C classifications are based upon age and quality of construction and finish.

Vacant Space:
Includes space available for lease or sublease.

Non-Competitive Space:
Includes owner occupied space and that space which is under long term lease.

Competitive Space:
Includes vacant space and space likely to be available within the next decade

BOMA

BUILDING OWNERS AND MANAGERS ASSOCIATION OF GREATER BOSTON
24 SCHOOL ST. • BOSTON 02108 • 523-2910

June 30, 1976

Dear Building Owner and Manager:

The Building Owners and Managers Association of Greater Boston is pleased to provide you with a copy of the 1976 Spring Boston Office Occupancy Survey.

A total of 104 buildings were surveyed in this Spring report, having a total of 14,174,623 square feet of rentable area. This is a sizeable portion of the total office market in the City and is an acceptable statistical sampling with which to analyze the general trends of the market.

The Report shows the Boston office space occupancy rate is 88.5 % with an over-all vacancy rate of 11.5 %. The vacancy rate will continue to be affected in subsequent surveys as the newly constructed owner-occupied high rise buildings are included in the survey. Several of these most recent buildings have not been included in this report in order to minimize the bias effect of this grouping.

We are presently in the process of revising the parameters prior to the next sampling in order to make the information more meaningful in today's market. Any suggestions that you have should be referred to Michael Manzo, Chairman of the Boston Affairs Committee, Michael Whalen, Managing Director of BOMA of Greater Boston, or myself.

We wish to thank the owners and managers who contributed reports for this survey. If additional copies of the report are needed they are available at the BOMA office - 523-2910.

Sincerely,

Dick

Richard W. Spaulding,
President

CM

Encs.

APRIL 1976

GREATER BOSTON REAL ESTATE BOARD

BUILDING OWNERS AND MANAGERS ASSOCIATION OF GREATER BOSTON

Office Vacancy Survey

Classification	Number of Buildings	Total Square Feet of Rentable Area	Total Square Feet of Vacant Area	Per Cent of Vacancy	Total Government Tenancy	Government Occupancy as a Per Cent of Total Rentable Area
DOWNTOWN:						
$10 and up	6	3,114,796	140,624	4.5 %	15,830	.5 %
$8 - $9.99	10	2,493,654	215,047	8.6	37,670	1.5
$7 - $7.99	16	1,126,008	132,200	11.7	75,214	6.7
$6 - $6.99	19	2,069,676	449,444	21.7	165,888	8.0
$5 - $5.99	16	1,056,088	240,288	22.7	99,852	9.4
$3 - $4.99	8	848,168	139,535	16.4	374,595	44.1
TOTAL	75	10,708,390	1,317,138	12.3 %	769,049	7.1 %
BACK BAY:						
$10 and up	4	1,329,399	-0-	-0- %	15,726	1.1 %
$8 - $9.99	4	1,290,980	11,316	.8	-0-	-0-
$7 - $7.99	3	440,307	100,054	22.7	-0-	-0-
$6 - $6.99	6	255,364	185,919	72.8	-0-	-0-
$5 - $5.99	6	73,580	13,488	18.3	23,976	32.5
$3 - $4.99	6	76,603	13,133	17.1	-0-	-0-
TOTAL	29	3,466,233	323,910	9.3 %	39,702	1.1 %
GRAND TOTAL	104	14,174,623	1,641,048	11.5 %	808,751	5.7 %

BOMA OF GREATER BOSTON

VACANCY SURVEY - Supplemental Data

Classification	Owner Occupied	Total Space That is Air Conditioned	Air Conditioned Space As % Of Total Space	Total Store Space	Vacant Store Space	Store Space Vacancy Rate
DOWNTOWN:						
$10 and up	526,886	3,114,796	100.0 %	83,086	9,200	11.0 %
$ 8 - $9.99	63,307	2,493,654	100.0	141,815	8,360	5.8
$ 7 - $7.99	150,963	1,198,708	93.9	84,226	27,600	32.7
$ 6 - $6.99	143,259	2,069,676	97.5	165,888	35,701	21.5
$ 5 - $5.99	82,946	918,664	86.9	99,121	27,572	27.8
$ 3 - $4.99	15,600	607,160	71.5	75,184	5,650	7.5
TOTAL	982,961	10,402,658	97.1 %	649,320	114,083	17.5 %
BACK BAY:						
$10 and up	598,903	1,329,399	100.0 %	8,400	-0-	-0-
$ 8 - $9.99	1,183,009	1,289,421	99.8	16,133	-0-	-0-
$ 7 - $7.99	600	440,307	100.0	17,158	-0-	-0-
$ 6 - $6.99	25,000	120,704	47.2	26,500	4,850	18.3
$ 5 - $5.99	6,699	55,975	76.0	22,647	-0-	-0-
$ 3 - $4.99	350	38,800	50.6	27,570	-0-	-0-
TOTAL	1,814,561	3,274,606	94.4 %	118,408	4,850	4.0 %
GRAND TOTAL	2,797,522	13,677,264	96.4 %	767,728	118,933	15.4 %

BUILDING OWNERS AND MANAGERS ASSOCIATION
OF GREATER BOSTON
Office Vacancy Survey - Comparative Statistic

Date of Survey	Number of Buildings Reported	Total Square Feet of Rentable Area	Total Square Feet of Vacant Area	Per Cent of Vacancy	Total Government Tenancy	Government Occupancy as a % of Total Rentable Area
April '68	164	14,778,786	496,196	3.4	424,397	2.9
October '68	163	14,898,795	404,925	2.7	516,057	3.5
April '69	165	15,765,742	463,805	2.9	601,336	3.8
October '69	166	15,790,142	372,234	2.4	686,914	4.4
April '70	155	15,271,985	252,389	1.7	633,249	4.1
October '70	152	15,294,929	372,280	2.4	646,003	4.2
April '71	155	16,005,859	678,704	4.2	720,632	4.5
October '71	139	16,132,245	1,307,183	8.1	560,937	3.5
April '72	135	16,147,731	1,184,698	6.9	661,583	3.9
October '72	132	16,056,089	832,004	5.2	780,270	4.9
April '73	116	15,882,012	883,510	5.2	913,087	5.7
October '73	119	15,567,226	1,673,464	10.7	773,565	5.0
April '74	89	13,447,956	801,485	6.0	607,006	4.5
October '74	116	16,283,377	1,271,714	7.8	1,063,706	6.7
April '75	101	14,044,035	1,094,665	7.8	950,380	6.8
October '75	105	15,322,861	1,142,453	7.5	1,027,826	6.7
April '76	104	14,174,623	1,641,048	11.5	808,751	5.7

Ryan, Elliott and Company, Inc.

24 Federal Street, Boston, Massachusetts 02110, (617) 357-8220

RE Real Estate

MEMORANDUM

TO: Melvin Epstein

FROM: Dan A. Woolley

DATE: July 14, 1976

RE: MARKET INFORMATION ON THE PROPOSED CONVERSION AND RENOVATION OF THE SOUTH STATION BUILDING

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1. Existing market rentals for first class office buildings in downtown Boston:

(a) 225 Franklin Street (State Street Bank building) - $11.00 to $12.00 per rentable square foot, excluding electricity. This is considered over the market for that building.

(b) 99 High Street - $8.50 to $9.50 plus electricity. There is substantial sublease space in this building and it is probably about the most competitive in the city.

(c) 100 Summer Street - $8.00 to $10.00 per square foot plus electricity.

(d) One Federal Street (Shawmut Bank) - $10.00 to $11.75 per rentable square foot excluding electricity.

(e) One Winthrop Square - $8.00 to $9.50 per square foot excluding electricity.

(f) 60 State Street - $9.00 to $12.00 per square excluding electricity.

(g) 175 Federal Street - $9.00 to $12.00 per square foot.

These rentals are all based on rentable square feet. The range is determined by size of space, location within the building

(lower or upper floors), length of lease, and the particular competitive objectives of the building owners. From this it is reasonable to say the South Station building, the $10.00 per square foot rental that we discussed yesterday, is within the range of existing competitive rentals in a comparable building.

2. With respect to the location, the transportation available at the site is superior to any other place in the city, but the location is still considered less than 100 percent as far as office locations go. Whether the two factors are offsetting can only be proven out in a rental program, but is a point which must be considered.

3. I have enclosed copies of our Ryan, Elliott and Company Survey of the Downtown Office Market running from 1971 through 1976. This shows the increase in Class A office space over roughly a five-year period. Prior to 1971, our records indicate approximately 3,675,000 square feet had been completed in the period 1957 to 1971. As of April 1, 1971, there was a total of 2,896,826 square feet of competitive space with a total vacancy of 156,000 square feet. In February, 1976, there was a total of 6,103,895 square feet of competitive space, while vacant space had increased to 1,387,783 square feet. While vacancies in the Class A space had increased by 1,231,044 square feet, the total inventory of competitive space had increased 3,207,069 square feet. Approximately 2,000,000 square feet of new space had been absorbed in under five years, or roughly 400,000 square feet per year. Considering the additional State office buildings and other noncompetitive space which absorbed potential tenants from the private office market, it is obvious a rather substantial amount of space has been absorbed, especially in light of the less than healthy economic climate in the period of 1973-1975.

4. New space coming on the market will include 60 State Street and the Fiduciary Trust Company at 175 Federal Street. That, coupled with approximately 1,200,000 square feet of existing first class space available, indicates a maximum of approximately 2,225,000 square feet available in the period through 1980. Given the problems in developing new office buildings in Boston, it would appear that even a continuation of 400,000 square feet per year over the next five years, we will be running into a shortfall of space by 1980. Certainly an addition of another 100,000 feet at South Station would not constitute a glut of the market.

5. Older buildings are being rented in the $7.00 to $8.00 per square foot range, and indications are that more and more

"deals" are being made as competition for tenants for these buildings become more severe. It is our observation that many tenants would prefer to pay a higher rent for first quality space, and the primary tenants in older buildings are those who are on a strict budget.

6. With respect to operating expenses, I suggested a 22 percent tax rate would result in a tax of $2.20 per square foot. Management has indicated operating expenses would run closer to $1.80 per square foot rather than the $1.65 that I had suggested to you; therefore, an overall tax and operating expense level of $4.00 per square foot would seem likely. This would leave approximately $6.00 a foot for debt service and therefore the economics and feasibility could do work from that basis.

7. As I mentioned, the BRA has had a number of studies conducted for the office and other markets in the city, and you should try to uncover those particular studies to be of assistance. We would also be pleased to work with you on developing a comprehensive marketability and feasibility study for the South Station; unfortunately, we would not be able to do it for free.

8. Please give me a call after you have had a chance to review this and see what else you need.

DAW

Tax-Exempt Financing of Community-Controlled Cable Television Facilities

James W. Perkins

Contents

Foreword

The communications revolution that has been underway worldwide has accelerated quantitatively in recent years, vastly increasing the variety and speed of commercial, political, and cultural interaction. Cable television (CATV) is one of the most exciting instruments of this reordering. While the transmission of electrical impulses via cable is not new, the integration of that method of communication with the sorting, recording, and reckoning capabilities of computers has tremendous social implications.

Many community development corporations (CDCs) understand the potential that CATV has for promoting the development of their areas. Their communities have needs, such as for more cost-effective training and education programs, a freer flow of "developmental" information, constructive artistic and political exchange—even more convenience in shopping—that could be served well by CATV. These CDC planners perceive as well the influence CATV might come to have on the nature and direction of economic, social, and political activity within the special impact regions they are striving to develop.

Accordingly, many CDCs have been interested in the possibility of owning CATV facilities. Such ownership would presumably carry with it responsibility for the allocation of jobs, the control of programming, and the determination of charges to consumers. Additionally, ownership by a CDC would maximize the utilization of government services, such as film libraries, information on employment opportunities, and so forth.

The problems a CDC might expect to encounter in negotiating for such ownership are many. To those familiar with the capital structure of the CDCs, it is not surprising that outside financing would be needed in order to undertake such a venture. Costs for CATV facilities range from about $5 million upward. Most regular commercial banks would not be inclined to lend their help, not only because the impact area's residents would probably have difficulty in servicing the required debt through monthly subscription fees, but also because such banks would be uncomfortable lending unorthodox developers such sums for a relatively new activity. The banks might not understand what a CDC is, and, if they did, they might still reject the request because of a fear of the concept of community control. Then again, even if doubt about the CDC's ability to obtain a franchise were removed by the CDC's having the franchise in hand

before the loan negotiations began, such banks might still demur by calling into question the CDC's ability, the area's need, etc.

As a result some CDCs have turned to the possibility of borrowing for CATV purposes from state and local governments via tax-exempt bond issuances through those agencies. Such a mechanism should make it possible for CDCs to borrow amounts otherwise unavailable at lower interest rates.

At the request of CCED, James W. Perkins, of the firm of Palmer & Dodge has sought to clarify the legal status of financing CDC ownership in such fashion. His method was to examine and compare the legal findings, insofar as they existed, that were applicable to (a) a community-controlled organization, (b) a special-purpose governmental instrumentality, and (c) a governmental unit. In the course of this investigation he focused on the following questions:

1. Does CATV qualify as "public purpose," so that state and local obligations can be issued, and, if so, can a nonprofit corporation formed to own CATV be exempted from state and local income, property, and franchise taxes?

2. Would bonds issued to finance CATV be treated as industrial development bonds, with the interest paid to bondholders on state and local obligations taxable by federal standards?

3. Is CATV likely to be treated as a charitable activity under federal tax law, with a CATV corporation thereby being qualified to receive deductible contributions, foundation grants, and exemption from federal taxes? Would income from CATV be related or unrelated business income for a tax-exempt CDC?

Apart from the CATV issue, this paper indirectly touches on many matters of general concern to CDCs. It is a model of the type of exhaustive legal research that is often necessary before proceeding with ventures. A careful reading may also suggest other areas where CDCs might successfully use governmental debt financing. Thus, although Perkins does not reach particularly hopeful conclusions about the possibility of municipal bond-financing of community-controlled CATV, his work casts light on other activities equally important to CDCs.

Michael Graves

Introduction

This study explores the legal feasibility of providing federal, state, and local tax exemptions for cable television facilities under the following alternative structures:*

Alternative A: A community development corporation (CDC) organizes a single-purpose, private nonprofit corporation to own and control local cable facilities.

Alternative B: A nonprofit corporation is organized as a single-purpose governmental instrumentality under state law to own and control the CATV facilities.

Alternative C: The facilities are owned by the city and controlled by a special single-purpose administrative board. (Where the local government is something other than a city, such as a town, township, or county, the system would be owned by that governmental unit.)

The intended tax benefits would include the financing of the system by bonds whose interest is exempt from federal income taxes (thus obtaining a lower interest rate), exemption of the system-owner from federal income taxes and state income and franchise taxes, and exemption of the facilities from local property taxes. Consideration is also given to the deductibility of contributions by individuals and corporations, eligibility for contributions by private foundations, and the possibility of funding the system in part by establishing a limited partnership with the local nonprofit or governmental entity as the general partner, and high-bracket taxpayers as limited partners receiving the tax benefit of partnership losses in exchange for their contributions of capital.

The system would be largely (or wholly) financed by bonds issued by the local nonprofit entity, by the single-purpose governmental instrumentality organized for the project, or by the city itself. The bonds would be "revenue bonds"—that is, bonds payable solely from the revenues of the system. The system-owner could manage the system itself, retain an experienced firm for this purpose, or hire a local management group in order to provide entrepreneurial opportunity in the community. The essential purposes of the

*This study discusses the pertinent legal issues, but policy choices and financial results or feasibility are outside its scope. Legal research for the study has been largely limited to federal tax law and Massachusetts constitutional, statutory, and case law, but, where feasible, comparative comments are made with regard to state law generally.

arrangement are to provide more communications services and a greater degree of local program control and local program input than would otherwise be financially feasible.

This study concludes that the proposed financing must meet state "public purpose" requirements, which require a showing that public benefit will be obtained that could not be obtained by ordinary commercial ownership and operation. The realization of profit to be used for other public purposes would not qualify for this purpose. Where an element of private profit is involved, provisions should be made for administrative approval of the proposed financing, with a relatively short period allowed for the invocation of judicial review by aggrieved parties.

Assuming that the public purpose test is met and assuming appropriate enabling legislation, the comparative legal results of the three basic alternative structures can be summarized in the chart below.

A Private Nonprofit Corporation	B Single-Purpose Governmental Instrumentality	C City Government with Special Administrative Board
Governing board can be chosen in whole or in part by the CDC	Board members must be elected by the people or appointed by public officers or by board members so chosen (subject to legislative power to change arrangement)	Same as B
May be subject to tax on system revenue as "unrelated business"	Probably exempt from federal income tax on system revenue	Exempt from federal income tax on system revenue
Tax-exempt bonds can be issued up to $1 million, or up to $5 million for projects costing up to $5 million. Result uncertain as to larger issues	Tax-exempt bonds can probably be issued for small and large projects, but interest of management company must be limited in case of an issue of more than $1 million for a project costing more than $5 million	Tax-exempt bonds can be issued for small and large projects, but interest of management company must be limited in case of an issue of more than $1 million for a project costing more than $5 million

A Private Nonprofit Corporation	B Single-Purpose Governmental Instrumentality	C City Government with Special Administrative Board
Can be exempt from state income and franchise taxes and local property taxes	Same as A	Same as A
Deductibility of individual and corporate contributions is uncertain	Same as A	Same as A
Eligibility for foundation assistance is uncertain and may turn on complex factual tests	Same as A	Eligibility is uncertain

The possibilities of obtaining capital contributions through a limited partnership are limited, principally because (a) it would foreclose the issue of more than $1 million tax-exempt bonds for a project costing more than $5 million, and (b) the tax benefits to the limited partners would be less secure and less in amount than in the case of a typical housing partnership.

Existing Massachusetts statutes are not clearly adequate for the proposed financing. Appendix A contains an outline of enabling legislation using Alternative C. Subject to review of the law in the particular state involved, the outline could be used in drafting legislation in any state.

These and other legal issues are discussed in greater detail in the chapters that follow. It should be borne in mind, however, that on January 28, 1976, the United States Treasury Department proposed new regulations relating to tax-exempt bonds which, if made final, would significantly affect Chapters 2 and 4.

Chapter I

Public Purpose: Applicability and Effect

Applicability of Public Purpose Test

States and their subdivisions and instrumentalities are organized for public (that is, governmental) rather than private purposes, and it is implicit under state constitutional law that public funds can only be expended for public purposes. For reasons discussed below, both the proceeds of the proposed bonds (which must be treated as public funds for this purpose) and the proposed exemptions from state and local taxes are subject to the public purpose test.

Under Alternative A (ownership by a private nonprofit corporation), the bonds would be issued by the corporation itself, or else the city would issue the bonds and loan the proceeds to the corporation (the city's bonds being payable solely from the payments to be made by the corporation on its loan from the city). If the bonds were issued by the corporation, they would be tax-exempt under federal law only if they were treated as issued "on behalf of" the city under Revenue Ruling 63-20, 1963-1 C.B. 24 (a federal income tax ruling). (For the federal requirements of such "on behalf of" treatment, see Chapter 4.)

Under Alternative B (ownership of a single-purpose governmental instrumentality), the bonds would be issued by that instrumentality (or issued by the city for it).

Under Alternative C (ownership by the city), the bonds would be issued by the city.

The proceeds of bonds issued by the city or by a single-purpose governmental instrumentality are public funds. Even if the bonds were issued "on behalf of" the city by a private nonprofit corporation, the eventual acquisition of the system by the city under Revenue Ruling 63-20 would have to be for a "public purpose." But since the bonds would be payable solely from funds derived from the

CATV operations, no governmental tax receipts would be committed to the payment of the bonds. It could, therefore, be argued that the bond proceeds would not be "public funds" in the constitutional sense.

In Massachusetts, the court has indicated that the proceeds of revenue bonds are subject to the public purpose test.[1] In every state, in the absence of clear precedent to the contrary, it should be assumed that the proceeds of revenue bonds are subject to a public purpose test.

The proposed exemption from local property taxes would also invoke the public purpose test. When property is used for commercial purposes, it cannot be singled out for exemption from local property taxes unless the primary purpose of the arrangement is a public purpose.[2] If the public purpose test is met so as to permit the property tax exemption, there should be no difficulty with respect to the exemption of the system-owner from state income and franchise taxes. There is no reason to apply a stiffer test to that aspect.

Effect of Public Purpose Test

Public Purpose Test Under State Law

CATV facilities would provide a vehicle for municipal and educational services which are traditional public purposes. But the system would also provide a commercial broadcast service to its subscribers, and engaging in commercial enterprise is not ordinarily a public purpose.[3] It follows that although the operation of a public utility is a public purpose,[4] mere realization of financial profit for public use is not a public purpose.

A cable system is analogous to traditional utility services in several respects. It uses public streets for its wires just as gas and electric utilities use streets for their pipes and wires. It may in some circumstances require the taking of easements by eminent domain or a right to use easements already taken by telephone or electric

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1. See Massachusetts Housing Finance Agency v. N.E. Merchants National Bank, 356 Mass. 202, 210, 249 N.E. 2d 599, 605 (1969); Opinion of the Justices, 354 Mass. 779, 785-786, 236 N.E. 2d 523, 527-528 (1968).

2. Cf. Cabot v. Assessor of Boston, 335 Mass. 53, 138 N.E. 2d 618 (1956), app. disd. sub nom. Cabot v. Alphen, 354 U.S. 907 (1957). See also Atlantic Refining Co. v. Assessors of Newton, 342 Mass. 200, 203, 172 N.E. 2d 827, 829-830 (1961).

3. Opinion of the Justices, 155 Mass. 598, 30 N.E. 1142 (1892); Opinion of the Justices, 182 Mass. 605, 66 N.E. 25 (1903).

4. Opinion of the Justices, 150 Mass. 592, 24 N.E. 1084 (1890).

companies. The system cannot practicably be provided by individuals for themselves, or by more than one party in the same territory except at higher cost.[5]

Also, under Federal Communications Commission rules, a system within a major television market must provide "at least one specially designated, noncommercial public access channel available on a first-come, nondiscriminatory basis."[6] This public access channel, plus the potential use of the system for commercial and noncommercial data transmission, provides utility-type services to senders as well as to receivers of communications materials.

For the foregoing reasons, cable television should be treated as a constitutional public purpose for the spending of public funds and should receive exemptions from state and local taxes where it has no private profit aspect. A city-supported system has been established in Frankfurt, Kentucky,[7] and in California, the validity of CATV as a lawful municipal purpose has been sustained by the attorney general.[8]

Although the generation of profit to be used for other public purposes is not itself a public purpose, the carrying of standard broadcasts and special municipal educational services are so interwoven that the subsidization of the latter by fees paid primarily for the former should be a valid public purpose. Moreover, if the public financing substantially improves the mix in favor of public and educational services, the actual use of a portion of the revenues for other public purposes (whether by a nonprofit corporation system-owner or by a governmental system-owner) should not destroy the public purpose status of the CATV operation.

Nevertheless, conservative courts may be hostile to government intrusion into CATV operation in view of the readiness of private companies to supply the service (including the noncommercial channels required by the FCC) and in view of the free speech questions that lurk behind every decision concerning who may use cable channels. Prudence suggests that the enabling legislation should provide a final and binding administrative procedure for determining in each case that the public advantage warrants a public cable system—at least where private profit is mixed with public funds or state or local tax exemptions.

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5. Cf. Opinion of the Justices, 150 Mass. 592, 597, 24 N.E. 1084, 1086 (1890); Opinion of the Justices, 155 Mass. 598, 605, 30 N.E. 1142, 1145 (1892); Opinion of the Justices, 182 Mass. 605, 608, 66 N.E. 25, 26 (1903).

6. 47 CFR s.76.251(a)(4). As to the power of the FCC to make a regulation of this character, see United States v. Midwest Video Corp., 406 U.S. 649 (1972), reh. den. 409 U.S. 898 (1972).

7. See Consolidated TV Cable Service v. Frankfurt, 465 F. 2d 1190 (1972).

8. 54 Ops. Cal. Atty. Gen. 135 (1971).

Severe public purpose problems are presented where there is to be substantial use of a public facility for private profit. In such a case, the project is not considered a public purpose project unless the legislation provides adequate standards for the control of nonpublic uses.[9]

The proposed CATV arrangement involves, or may involve, private profit in at least three respects: (1) the sharing of profits with limited partners; (2) the use of channels for commercial broadcasts; and (3) a management contract, which may provide incentive compensation based on a percentage of gross revenues or a percentage of net revenues or a combination of the two. The management contract and limited partnership are particularly sensitive. Although the decision was based on statutory rather than constitutional grounds, it is important to note that the Massachusetts court has struck down a management contract because it delegated too much decision-making to the manager. The court was particularly critical of the "unusual character" of the contract whereby the manager was to be paid 40 percent of net operating revenues.[10] The court has also faulted other legislation for having inadequate standards regarding management contracts.[11]

The court has suggested that continuous utility-type rate regulation is one way to provide adequate control over the private profit to be derived from a tax-exempt facility.[12] Limited-dividend arrangements have also been sustained as the basis for favored tax treatment.[13]

The court has also sustained (1) the tax exemption of public land leased for parking purposes without any rate or profit limitation at all where the lessee was to build the facility and was to be subject to competitive forces, and (2) the taking of property for the building of garages to be leased to private operators with maximum rate provisions in the leases but no continuing supervision over rates.[14]

Obviously the requirements vary from one situation to another. For example, if the bonds (or the underlying obligations) are guaranteed by the manager in order to facilitate the marketing of the bonds, it would seem reasonable to offer a greater profit potential to the manager than would otherwise be permissible.[15] Private parties

9. Opinion of the Justices, 356 Mass. 775, 795, 250 N.E. 2d 547, 558 (1969).

10. Gould v. Greylock Reservation Commission, 350 Mass. 410, 424, 215 N.E. 2d 114, 125 (1966).

11. Opinion of the Justices, 356 Mass. 775, 797, 250 N.E. 2d 547, 559 (1969).

12. See Opinion of the Justices, 341 Mass. 738, 758, 167 N.E. 2d 745, 756 (1960).

13. Opinion of the Justices, 334 Mass. 760, 135 N.E. 2d 665 (1956).

14. Cabot v. Assessors of Boston, 335 Mass. 53, 138 N.E. 2d 618 (1956); Court Street Parking Co. v. Boston, 336 Mass. 224, 143 N.E. 2d 683 (1957).

15. Cf. Gould v. Greylock Reservation Commission, 350 Mass. 410, 425, 215 N.E. 2d 114, 125 (1966).

may presumably be allowed such use of the facilities and such profit potential as may be necessary to provide increased public use or to make public use possible by making the project feasible.

The legislature must either establish such restrictions on private use and private profit as are appropriate to the particular transaction or must establish adequate standards for the guidance of administrative officials in doing so. If the legislature fails to meet this responsibility, its declaration that the legislation is for a public purpose will not survive judicial scrutiny.[16]

Since the economics of CATV will vary from place to place, it would be difficult for the legislature to establish a single set of restrictions for all communities. The power to determine the right controls for each situation should be delegated to administrative officials under appropriate standards set forth in the legislation.

FCC regulation is not by itself adequate to meet state public purpose requirements because FCC rules are subject to change without state approval and were written, and would be interpreted, in the context of straight commercial operation without property or income tax exemption or tax-exempt financing. The question remains whether the FCC rules preclude the establishment of adequate controls to meet state public purpose tests. State and local regulation of CATV were not precluded by the Federal Communications Act prior to actual FCC regulation but are subject to pre-emption by the FCC now that the FCC has entered the field comprehensively.[17]

FCC rules permit franchise applications by government entities.[18] The rules *require* approval of initial subscriber rates (and changes therein) by the franchising authority (that is, the city or town in Massachusetts).[19] Rates are to be "fair to the system and to the subscribing public."[20]

The FCC *prohibits* state and local regulatory authorities from requiring more access channels for local program origination ("cablecasting") than FCC minima, or from requiring more restrictive operating rules, without FCC approval.[21] If this pre-emption is circumvented by favoring applicants who promise to exceed the FCC minima, such abuses will be critically examined by the FCC.[22]

Although a franchising authority cannot require more generous

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16. Opinion of the Justices, 356 Mass. 775, 796, 250 N.E. 2d 547, 558 (1969).

17. TV Pix v. Taylor, 304 F. Supp. 459 (1968), aff'd per curiam 396 U.S. 556 (1970).

18. 47 CFR §76.16(a).

19. 47 CFR §76.31(a)(4).

20. 37 Fed. Reg. 3276, par. 183 (February 12, 1972).

21. 47 CFR §76.251(a)(11)(iv) and (b). See also 37 Fed Reg. 3270-3271, par. 131-134 (February 12, 1972).

22. 37 Fed. Reg. 3271 (n. 70).

local programming access without FCC approval, it is not clear whether an operator can voluntarily provide more generous access without approval.[23] If such additional public service is made feasible by tax exemptions rather than by increased subscriber fees or commercial charges, it would not "unduly burden systems [or] achievement of [the FCC's] basic goals," which are the evils mentioned in the FCC's warning.[24]

It seems reasonable to conclude that the FCC has not pre-empted the field to such an extent as to preclude a state from adopting necessary public purpose standards. Taking the FCC rules as given, a determination can still be made under state law regarding whether or not the financing will provide a substantial public benefit that is not otherwise available and whether more profit potential has been given to private interests than is necessary to accomplish the public objectives of the financing.

The arrangement needed to best serve the public interest will vary from place to place, and it will be exceedingly difficult to establish beyond reasonable doubt that a particular transaction involving private profit meets state constitutional requirements unless a mechanism is provided for making a final and binding determination to that effect. To this end, where a management contract or other comparable profit participation is mixed with public funds or state or local tax exemptions, there are four suggested requirements: (1) each financing should be made subject to the approval of a regulatory agency acting under adequate standards set forth in the legislation, (2) the regulatory agency should be required to make specific findings of public benefit before granting approval and a general finding to the effect that "the project will constitute a public use and benefit,"[25] (3) provision should be made in the enabling legislation for judicial review of the findings and approval, and (4) a relatively short period (say, 60 to 90 days) should be established in which proceedings for judicial review may be initiated. A period of 30 days has been held adequate.[26]

The Rhode Island court has expressed some uncertainty regarding the constitutionality of such a short period after published notice (as compared to individual notice).[27] But published notice should suffice for a determination of public purpose (if notice is required at

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23. See 37 Fed. Reg. 3271, par. 132.

24. See 37 Fed. Reg. 3271 (n. 70).

25. Cf. Mass. St. 1960 chap. 652, § 13.

26. Dodge v. Prudential Ins. Co., 343 Mass. 375, 382, 179 N.E. 2d 234, 240 (1961).

27. See Corrado v. Providence Redevelopment Agency, 105 R.I. 470, 482, 252 A. 2d 920, 927 (1969), cert. den. 396 U.S. 1022 (1970), reh. den. 397 U.S. 1031 (1970).

all) since the proceedings would affect public rights or interests and would not adjudicate private rights.[28]

Although proceedings of the proposed character are often taken at the state level in such mixed public-private areas as urban renewal and industrial development, they may constitutionally be taken at the local level.[29] Such approval by a sponsoring city board would, however, be self-serving and vulnerable. If the approval is to be at the state level, it might be given by the state CATV commission (if any), such as the commission established by Mass. G.L. c.166A § 2. If the approval is to be at the local level, it might be given by the cable franchising authority, which in Massachusetts is the mayor, city manager, or board of selectmen. (Appendix A [par. 17] follows the latter course, and, in the case of a city, provides for concurrence by the city council in order to avoid legal questions which might arise from combining initiatory and approval functions in the mayor or manager). These proceedings could be a part of the proceedings granting the franchise.

The suggested proceedings should not be necessary in one special case. If the bonds are issued by a private nonprofit corporation "on behalf of" the city, with no state or local tax exemptions, and if outside management (or any limited partnership) is to end upon payment of the bonds and transfer of the system to the city pursuant to Revenue Ruling 63-20 (1963-1 C.B. 24), there would not be a simultaneous mix of public money and private benefit.

In any event, if adequate procedures are set up to establish that the public purpose test is satisfied in Massachusetts, it should in general be no more difficult to meet public purpose requirements in other states. Massachusetts law on public purpose (as affected by private benefit) is more developed than is generally the case elsewhere.

Public Purpose Test Under U.S. Constitution

If there is also an implied public purpose requirement in the 14th Amendment to the United States Constitution, it can further be said that satisfying the Massachusetts test should satisfy the federal test.[30]

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28. Trager v. Peabody Redevelopment Authority, 367 F. Supp. 1000 (1973); cf. Reid v. Acting Commissioner, 1972 Mass. A.S. 1209, 284 N.E. 2d 245.

29. Opinion of the Justices, 112 N.H. 42, 288 A. 2d 697, 699 (1972). See also Mass. St. 1960 chap. 652, § 13 as approved in Dodge v. Prudential Ins. Co., 343 Mass. 375, 179 N.E. 2d 234 (1961).

30. See Dodge v. Prudential Ins. Co., 343 Mass. 375, 387, 179 N.E. 2d 234, 243 (1961), discussing Berman v. Parker, 348 U.S. 26 (1954).

Related Constitutional Limitations in Massachusetts

In Massachusetts there are additional provisions that go beyond implicit public purpose requirements. For example, the 46th Amendment (the "Anti-Aid" Amendment) as amended by the 103rd Amendment provides that

> no grant, appropriation or use of public money or property or loan of credit shall be made or authorized by the commonwealth or any political division thereof for the purpose of founding, maintaining or aiding any infirmary, hospital, institution, primary or secondary school, or charitable or religious undertaking which is not publicly owned and under the exclusive control, order and supervision of public officers. . . .

This presents no problem in the case of bonds payable solely from the revenues of the facilities financed by the bonds, since the proceeds of such bonds are not "public money" under the 46th Amendment (even though they are subject to public purpose requirements) and the bonds are not a "loan of public credit."[31]

It then follows that the facilities so financed are also not "public property" under the 46th Amendment. Nevertheless, because of this amendment, if the bonds were issued as "general obligations" of the city (that is, payable from the general funds of the city) for a system controlled by a nonprofit corporation, or were issued by such a corporation and guaranteed by the city, this amendment would require the corporation to be a governmental instrumentality rather than a private corporation, and serious questions would arise regarding the extent to which management could be delegated under a management contract.

The 62nd Amendment (as amended by the 84th Amendment) provides:

> Section 1. The commonwealth may give, loan or pledge its credit only by a vote, taken by the yeas and nays, of two-thirds of each house of the General Court present and voting thereon. The credit of the commonwealth shall not in any manner be given or loaned to or in aid of any individual, or of any private association, or of any corporation which is privately owned and managed.

31. Opinion of the Justices, 354 Mass. 779, 784, 785-786, 236 N.E. 2d 523, 527-528 (1968).

> Section 3. . . . [T]he commonwealth may borrow money only by a vote, taken by the yeas and nays, of two-thirds of each house of the general court present and voting thereon. The governor shall recommend to the general court the term for which any loan shall be contracted.

Since the proposed structure involves no borrowing by the commonwealth and no pledge of the credit of the commonwealth, these provisions present no obstacle.[32]

32. Opinion of the Justices, 354 Mass. 779, 784-785 236 N.E. 2d 523, 527 (1968).

Chapter 2

Composition of the Governing Board

Private Nonprofit Corporation

If the system is owned by a private nonprofit corporation (Alternative A), the corporation may be organized by one or more individuals or corporations as "incorporators."[1] Thus, it may be organized by a CDC.

The corporation may, but need not, have "members" and may establish in its articles of organization or bylaws the manner of choosing members.[2] The corporation may also determine by its bylaws "the manner in which and the officers and agents by whom its purposes may be accomplished . . . and the tenure of office of the directors and officers and the manner of their selection and removal."[3]

Thus the governing board can be chosen by a "parent" CDC, either directly by appointment of the board or indirectly by the appointment of the members, or the officers and directors of the CDC may serve *ex officio* as the governing board of the nonprofit corporation. However, if the parent CDC were a for-profit corporation, it might be expected to exercise its control of the subsidiary nonprofit corporation for its own profit-making ends, and there might be greater difficulty in obtaining federal, state, and local tax exemptions for the nonprofit corporation.

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1. Mass. G.L. c.180 § 3.
2. Mass. G.L. c.180 § 3.
3. Mass. G.L. c.180 § 6A.

Single-Purpose Governmental Instrumentality

If the system is owned by a single-purpose governmental instrumentality (Alternative B), the governing board would have to be chosen in a manner consistent with our democratic constitutional traditions. Basically, there are three methods by which board members could constitutionally be chosen: (1) direct election by the people residing in the territory served, (2) appointment by other public officers, and (3) appointment by other board members previously chosen by either of the two other methods. Any one of these three methods could be used for the entire board, or they could be used in combination.

Election by members would be the constitutional equivalent of election by the people if membership is open to all residents without mandatory dues. Mandatory dues as a condition of voting could be considered a poll tax which well might violate the United States Constitution.[4] Conversely, exclusion of the nonpoor from the election process would present similar constitutional problems.

It is possible that voting for a governmental CATV board could be limited to subscribers. In a very limited class of special-purpose governmental instrumentalities, voting may be limited to those most especially affected. Specifically, in water storage districts, the Supreme Court of the United States has held that voting may be limited to landowners.[5]

Alternatively, governmental board members who have been elected by the people or appointed by other public officers may be authorized to appoint additional board members. Or the board can be entirely self-perpetuating if it was originally elected by the people or appointed by public officers.[6] (The law may be different, however, in any state where a constitutional right to elect public officials may exist or where constitutional home rule provisions may preclude state legislative authorization of self-perpetuating local boards.)[7]

The United States Supreme Court has declined to review a court of appeals decision to the effect that a self-perpetuating local board

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4. Harper v. Virginia Board of Elections, 383 U.S. 663 (1966).

5. Salyer Land Co. v. Tulare Lake Basin Water Storage District, 410 U.S. 719 (1973); Associated Enterprises, Inc. v. Toltec Watershed Improvement District, 410 U.S. 743 (1973).

6. Adams v. Plunkett, 274 Mass. 453, 175 N.E. 60 (1931).

7. Cf. Milliken v. Littleton, 1972 Mass. A.S. 751, 753 (n. 3), 281 N.E. 2d 285, 287 (n. 3).

does not violate the "Republican Form of Government" and equal protection clauses of the United States Constitution.[8] It has been indicated, however, that "some questions" under the Republican Form of Government clause may be justiciable by courts.[9] Nevertheless, although the result is uncertain until the case is decided, it is unlikely that the Supreme Court would invalidate self-perpetuating, single-purpose boards under either that clause or the equal protection clause if the arrangement is subject to legislative change.

The *Adams* case in Massachusetts implies that the original membership of a special-purpose governmental board can be subject to approval of a private party (such as the CDC) and holds that, through restricted gifts to the enterprise, the governing arrangement can be made immune from legislative change. But the *Adams* case is of questionable authority in view of its failure to consider the Republican Form of Government clause. It is doubtful that an instrumentality with a board chosen by a private party or immune from legislative change would be recognized as a governmental instrumentality for federal tax purposes (see page 20 below).

Even if the original board members are not made legally subject to CDC approval, the CDC, as proponent of the enterprise, may still be able to influence their election or appointment, and the practical result may be the same.

Special Administrative Board for City-Owned System

The considerations applicable to a single-purpose governmental instrumentality, as just discussed, are substantially the same as those applicable to a special administrative board in the case of a city-owned system. Under appropriate legislative authorization, the members of such a city board may be elected by the people or appointed by other public officers. Or the board may be wholly or partially self-perpetuating if the original members are elected by the people or appointed by other public officers—unless such an arrangement is precluded by state constitutional provisions not existing in Massachusetts. Subject to state constitutional provisions for local home rule, the arrangement should be considered subject to legislative change.

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8. Cantwell v. Board of Trustees for Utilities, 409 U.S. 984 (1972). See also 41 USLW 3214 (Oct. 17, 1972).

9. See Kohler v. Tugwell, 292 F. Supp. 978, 985 (1968), aff'd 393 U.S. 531 (1969). See also Burger v. Judge, 364 F. Supp. 504, 508 (1973), aff'd 414 U.S. 1058 (1973). Contra, Brenner v. School District, 315 F. Supp. 627, 628 (n. 1) (1970), aff'd 403 U.S. 913 (1971).

Chapter 3

Exemption of System Income from Federal Income Taxes

Exempt Status Generally

The first part of this chapter examines the status of the system-owner as an exempt organization for federal income taxes. However, even if it is an exempt organization, it may be subject to tax on system revenues as "unrelated business income," which is discussed in the second half of the chapter. Accordingly, in order to achieve effective exemption, there must be both exempt status and freedom from the unrelated business income tax.

Exempt Status of Private Nonprofit Corporation

It is not at all clear that the proposed nonprofit corporation (Alternative A) could obtain exempt status under the Internal Revenue Code. The potential exemptions are as follows:

(a) "corporations . . . organized and operated exclusively for . . . charitable, scientific, . . . or educational purposes";[1]

(b) "civic leagues or organizations . . . operated exclusively for the promotion of social welfare";[2]

(c) "clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes."[3]

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1. Internal Revenue Code, §501(c)(3).
2. Internal Revenue Code, §501(c)(4).
3. Internal Revenue Code, §501(c)(7).

It is preferable that the exemption be obtained under (a) above in order to permit deductions for individual and corporate contributions [§ 170(c)(2)], to avoid "industrial development bond" treatment (see Chapter 4), and to qualify for contributions by private foundations [§ 4942(g)(1)(A)].

Exemption has been denied for cable systems under (b) and (c) above. The denial of "social welfare" status was because service was limited to subscriber-members. However, the 1954 ruling[4] indicated at page 132 that "The function of such an organization is distinguishable from that of one which is in the business of broadcasting and which controls the nature of its programs and the extent to which such programs promote social welfare." A cable system is still not regarded as a broadcaster for copyright purposes.[5]

The nonprofit corporation might be able to surmount the adverse CATV rulings and obtain exemption under (a) above on the following grounds: (1) The system would provide municipal and educational services, (2) The system would provide for local program origination, (3) FCC rules require that service be extended to a substantial percentage of the franchise area each year,[6] and (4) Membership in the corporation could be made available to all residents in the area rather than to subscribers only.

Nevertheless, since the service would be available only to subscribers and it might take a substantial time to provide service to the entire franchise area, no assurance can be offered that exemption would be forthcoming. A revenue-sharing management contract might make it more difficult to obtain an exemption ruling.

Exempt Status of a Single-Purpose Governmental Instrumentality

If the system-owner is established under state law as a governmental instrumentality, it may have exempt status for federal income tax purposes either (a) implicitly (and perhaps constitutionally) as a public instrumentality of the state, (b) expressly as an exempt organization under Section 501(c)(3) or (4) of the Internal Revenue Code, or (c) its income (except for "unrelated business income") may be expressly exempt as "income derived from any public utility or the exercise of any essential governmental function and accruing to a State . . ., or any political subdivision thereof" under Section 115(a)(1) of the Internal Revenue Code.

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4. Rev. Rul. 54-394, 1954-2 C.B. 131; Rev. Rul. 55-716, 1955-2 C.B. 263; cf. Rev. Rul. 62-167, 1962-2 C.B. 142.

5. Teleprompter Corp. v. Columbia Broadcasting System, 415 U.S. 394 (1974).

6. 47 CFR §76.31(a)(2).

Implicit Exemption

Federal income taxes are imposed on "individuals" and "corporations."[7] States and municipalities are not "corporations" for this purpose, and so the income directly received by them "without the intervention of the corporate form," whether from "governmental" or "proprietary" activities, is not taxed under the Code, even though the activity may be subject to federal excise taxes.[8] No opinion was expressed in the cited memorandum, however, about whether income received directly by a state or municipality from a proprietary activity is constitutionally immune from federal taxation.[9] Income from the operation of state liquor stores is exempt under existing statutes, at least where "a large portion of the profits" is used for regular governmental purposes.[10]

The proposed single-purpose instrumentality would have "corporate form;" it would not be supported by governmental tax receipts, it might or might not turn over profits to the city for general governmental purposes, and its activity might be deemed "proprietary." Nevertheless, as a "state instrumentality" or "governmental unit" or "political subdivision" under state law, it is highly likely that it would be implicitly exempt from federal income taxes as a governmental instrumentality.[11]

Express Exemption

A single-purpose governmental instrumentality organized as a body politic and corporate distinct from the city can obtain exemption under section 501(c)(3) or (4) if it otherwise qualifies.[12] Its eligibility for this exempt status would be the same as that of a private nonprofit corporation. As indicated above, the exempt status of a private nonprofit CATV corporation would be uncertain under Section 501(c). Similarly, no assurance can be offered that a special governmental instrumentality organized for CATV purposes would enjoy exempt status under Section 501(c).

In order for the income of a single-purpose governmental instrumentality to be generally exempt under Section 115(a)(1), these factors must coalesce: the income must "accrue" to a "political

7. Internal Revenue Code, §§ 1 and 11.

8. G.C.M. 14407, XIV-1 C.B. 103 (1935), superseded by Rev. Rul. 71-131, 1971-1 C.B. 29. See also Rev. Rul. 62-66, 1962-1 C.B. 83.

9. See XIV-1 C.B. 103, 107.

10. G.C.M. 13745, XIII-2 C.B. 76 (1934), superseded by Rev. Rul. 71-132, 1971-1 C.B. 29.

11. See Rev. Rul. 55-319, 1955-1 C.B. 119; Rev. Rul. 57-151, 1957-1 C.B. 64; Rev. Rul. 60-384, 1960-2 C.B. 172.

12. Rev. Rul. 55-319, 1955-1 C.B. 119; Rev. Rul. 60-384, 1960-2 C.B. 172; Rev. Rul. 74-15, 1974-1 C.B. 126.

subdivision," and the income must be derived from a "public utility" or an "essential governmental function."

Without tax, regulatory, eminent domain, or other "sovereign power," it is doubtful under current IRS thinking that the proposed instrumentality would qualify as a "political subdivision."[13] Also, Section 115(a)(1) may not apply to income earned directly by a political subdivision.[14] It is very doubtful, moreover, that cable television is an "essential governmental function."[15]

It is also uncertain whether cable television is a "public utility" for the purposes of Section 115(a)(1). It would not be a public utility under Sections 167(1)(3)(A) and 247(b)(1), but it might be a public utility under Section 46(c)(3)(B). On the other hand, a market place and auditorium has been held to be a public utility for tax exemption purposes.[16]

On the whole, the exempt status of a single-purpose governmental CATV entity is doubtful under the express provisions of Sections 115(a)(1) and 501(c), but a claim of implicit exempt status appears to be well-grounded.

Exempt Status of City as System-Owner

As already noted, states and municipalities are neither individuals nor "corporations" for federal income tax purposes and so are implicitly exempt from federal income taxes, which are imposed on individuals and corporations. Accordingly, the exempt status of a city as system-owned appears to be fairly clear.

Unrelated Business Income

Even if the system-owner enjoys general tax-exempt status under the Internal Revenue Code, a question remains whether its revenues are (in whole or part) taxable as "unrelated business income." The unrelated business income tax is imposed on organizations that have exempt status under Section 501(c).[17] Since a private nonprofit corporation could have tax-exempt status only by reason of Section 501(c), it would be subject to the tax if it had unrelated business income.

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13. Regulations § 1.103-1(b); cf. Rev. Rul. 73-563, 1973-2 C.B.24.

14. G.C.M. 14407, XIV-1 C.B. 103, 104 (1935), superseded by Rev. Rul. 71-131, 1971-1 C.B. 29.

15. Cf. Maryland Savings-Share Insurance Corp. v. U.S., 308 F. Supp. 761 (1970), rev'd on another issue 400 U.S. 4 (1970); Troy State University, 62 T.C. 493 (1974).

16. I.T. 2436, VII-2 C.B. 147, 149 (1928).

17. Internal Revenue Code, § 511(a)(2)(A).

Unrelated business income is income from a trade or business that is not substantially related (aside from the need for funds) to the basis on which the exempt status rests.[18] Even if a trade or business is part of a larger aggregate on which the exemption is based, the trade or business is unrelated unless it is by itself a basis of the exempt status.[19]

The essence of a nonprofit or governmental CATV operation is to improve the program mix by using revenues primarily paid for commercial broadcasts to subsidize educational, municipal, and other locally controlled public services. Therefore, unless carrying commercial broadcasts is itself a basis of the exemption (which is doubtful), the profit derived from fees paid to receive commercial broadcasts may be taxable as unrelated business income.[20]

A single-purpose governmental instrumentality may qualify as an expressly exempt organization under Section 501(c) of the Internal Revenue Code even if it is also implicitly exempt.[21] If it is an exempt organization under this Section, however, it may be subject to the tax on unrelated business income on the same terms as a private nonprofit corporation, unless its status as a governmental instrumentality implicitly overrides Section 511(a)(2)(A).

A governmental instrumentality is not an exempt organization under Section 501(c)(3) unless it requests the exemption.[22] But it can be an exempt organization under Section 501(c)(4) without asking, and this status could subject it to the tax on unrelated business income.

Accordingly, it is possible that a single-purpose governmental instrumentality would be subject to a tax on system revenue as unrelated business income. But it is more likely that a governmental instrumentality would be implicitly exempt from the tax on unrelated business income as well as the tax on income generally.[23] One might question, though, whether implicit exemption from the unrelated business income tax would be lost by obtaining explicit exempt status under Section 501(c)(3) in order to avoid industrial

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18. Internal Revenue Code, §§512(a)(1) and 513(a).

19. Internal Revenue Code, §513(c).

20. See Regulations, §1.513-1(d)(4)(iii) and (iv) (example 4), which treats radio advertising revenues as "unrelated" to the classical music programs generating the revenues where advancement of public interest in classical music is the purpose of the nonprofit organization.

21. Rev. Rul. 55-319, 1955-1 C.B. 119; Rev. Rul. 60-384, 1960-2 C.B. 172; Rev. Rul. 74-15, 1974-1 C.B. 126.

22. Internal Revenue Code, §508(a).

23. See Rev. Rul. 55-319, 1955-1 C.B. 119; Rev. Rul. 57-151, 1957-1 C.B. 64; Rev. Rul. 60-384, 1960-2 C.B. 172.

development bond treatment or to secure gifts and grants from individuals, corporations, and foundations (see Chapters 4 and 6).

A general purpose municipality is not an exempt organization under Section 501(c).[24] Since for present purposes, the unrelated business tax is imposed only on 501(c) organizations, a city should be immune from the unrelated business tax on its CATV revenues.

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24. See Rev. Rul. 62-66, 1962-1 C.B. 83.

Chapter 4

Exemption of Bond Interest from Federal Income Taxes

Eligibility of Issuer for Exemption of Bond Interest

In order to obtain exemption of the bond interest from federal income taxes, two requirements must be met. First, the bonds must be "issued by or on behalf of" "a State . . . or any political subdivision" thereof.[1] Second, the bonds must not be "industrial development bonds" or, if they are, they must qualify as an exempt "small issue."[2]

Eligibility of Private Nonprofit Corporation

If a private nonprofit corporation is the system-owner (Alternative A), the bonds might be issued by the private corporation, or the city might issue the bonds and loan the proceeds to the private corporation.

The city would unquestionably qualify as a political subdivision eligible to issue tax-exempt bonds; a nonprofit corporation, however, can also issue tax-exempt bonds if it issues them "on behalf of" a city.[3] Pursuant to Revenue Ruling 63-20 (1963-1 C.B. 24, at

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1. Internal Revenue Code, § 103(a)(1); Regulations, § 1.103-1(b).
2. Internal Revenue Code, § 103(c).
3. Regulations, § 1.103-1(b).

page 25), this may be done by a private corporation only if the following requirements are met:

> (1) the corporation must engage in activities which are essentially public in nature; (2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness); (3) the corporate income must not inure to any private person; (4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and (5) the corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.

The intent of test (3) might be violated, however, by a revenue-sharing management contract.

Moreover, although the "on behalf of" procedure has been frequently used in many states, it is not clear that state law implicitly authorizes private corporations to issue bonds "on behalf of" municipalities in every state for CATV purposes without special enabling legislation. The hurdles of Revenue Ruling 63-20 could be avoided by using the city as the issuer of the bonds even if a private nonprofit corporation is to be the system-owner.

Eligibility of Single-Purpose Governmental Instrumentality

If a special governmental instrumentality is the system-owner (Alternative B), the bonds could be issued either by the special instrumentality or by the city. As indicated above (see page 22), it is doubtful that the special governmental instrumentality would qualify as a "political subdivision." However, as in the case of a private corporation, the special instrumentality can issue tax-exempt bonds if it issues them "on behalf of" the city.[4]

"On behalf" financing by a governmental instrumentality is not subject to the same requirements which apply to "on behalf" financing by a private corporation.[5] The essential features of "on behalf" financing by a governmental instrumentality, as gleaned from Revenue Rulings 57-187 and 60-248, appear to be:

1. legislative authorization to engage in the activity and issue the bonds;

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4. Rev. Rul. 57-187, 1957-1 C.B. 65; Rev. Rul. 60-248, 1960-2 C.B. 35.

5. See Rev. Rul. 63-20, 1963-1 C.B. 24, 26-27.

2. (in the case of a local instrumentality) approval of the creation of the instrumentality by the governing body of the city;

3. choice of the governing board of the instrumentality by public officers or by popular election (see Chapter 2 above);

4. exemption of the instrumentality from state and local income, corporation excise and property taxes (it is believed that this is no longer considered necessary but a ruling would be required to confirm this change in I.R.S. practice); and

5. "[u]pon dissolution of [the instrumentality], the title to all property owned by it shall vest in and become the property of the" city.[6]

Although an IRS ruling might be desirable, there should be no insurmountable difficulty in drafting enabling legislation under which a special governmental instrumentality could be organized for CATV purposes with power to issue tax-exempt bonds "on behalf of" the city pursuant to these revenue rulings. On the other hand, if the city issued the bonds for the benefit of the special instrumentality, there would be no question about the eligibility of the city as a "political subdivision."

Eligibility of City as System-Owner

If the system is owned by the city, the city would issue the bonds and, as previously stated, would qualify as a "political subdivision" permitted to issue tax-exempt bonds under Section 103(a) of the Internal Revenue Code. It would still be necessary, however, to avoid "industrial development bond" treatment, as discussed below.

Effect of Guarantee by Management Company

If a management company guarantees the bonds (or guarantees the loan of the bond proceeds by the issuer to the system-owner), the bonds would still be treated as obligations of the issuer even if the issuer defaults and the management company pays the interest. Thus the exemption of the interest would not be adversely affected (unless the management contract causes industrial development bond treatment as discussed below).[7]

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6. 1957-1 C.B. 66.

7. Rev. Rul. 73-263, 1973-1 C.B. 49. See also Unpublished I.R.S. Ruling, American Municipal Bond Assurance Corporation, June 10, 1971.

Taxation of Bond Interest as Interest on Industrial Development Bonds

Even if the issuer is qualified to issue tax-exempt bonds either as or "on behalf of" a political subdivision, the interest may still be taxable if the bonds are "industrial development bonds" and are not an exempt "small issue."[8]

Would the bonds be "industrial development bonds"? Under Section 103(c)(2) and (3) of the Internal Revenue Code, a bond is an "industrial development bond" if:

1. a "major portion" of the bond proceeds is to be used directly or indirectly in a trade or business carried on by a nonexempt person or in an "unrelated trade or business" carried on by an exempt organization (this is the "trade or business test"), *and*

2. payment of a "major part" of the principal or interest is to be secured by "property used . . . in a trade or business" or "derived" from payments in respect of property, or borrowed money, used in a trade or business" (this is the "security interest test").

(A "major portion" or "major part" means more than 25 percent.[9] A nonexempt person is any person other than a "governmental unit" or a nonprofit corporation exempt from income taxes under Section 501(c)(3).[10] For "major portion" or "major part" purposes, the interests of all nonexempt persons are aggregated.)[11]

Even if a bond meets the "trade or business test" and the "security interest test" and is, therefore, an "industrial development bond," it is not necessarily taxable. If it is issued for one or more of the purposes listed in Section 103(c)(4) and (5), which *do not* include cable television, or if it is a "small issue" under Section 103(c)(6), it is tax-exempt in the hands of any investor who is not "a substantial user of the facilities or a related person" under Section 103(c)(7). The "small issue" exemption will be discussed later. We are dealing here with the threshold question of whether the bonds would be within the definition of industrial development bonds.

If a private nonprofit corporation or special governmental instrumentality is used (Alternative A or B), all of the bond proceeds would be used directly in the trade or business of that corporation or instrumentality, and all of the principal and interest payments would be directly derived from that trade or business. Therefore, if the

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8. Internal Revenue Code, § 103(c).

9. Regulations, §§ 1.103-7(b)(3)(iii) and (5)(i)(b).

10. Internal Revenue Code, § 103(c)(3).

11. Regulations, § 1.103-7(b)(3)(iii) and (5)(i)(b).

nonprofit corporation is not an exempt organization under Section 501(c)(3), or if the subscription fees are unrelated business income of the corporation (see Chapter 3 above), or if the special instrumentality is not a "governmental unit," the bonds would be industrial development bonds.

The exempt status of the nonprofit corporation under Section 501(c)(3) cannot be assured (see Chapter 3). As to the status of the special instrumentality as a "governmental unit," the regulations define "governmental unit" as a state or "political subdivision."[12]

This definition would appear to exclude a special governmental CATV instrumentality, since such an instrumentality would probably not pass muster as a "political subdivision" (see page 22 above). But it is believed that this is neither a correct nor an intended interpretation of the statutory phrase "governmental unit," and that a governmental instrumentality would qualify as a "governmental unit" and, hence, as an "exempt person," whether or not it is also a "political subdivision." A ruling on this point might be desirable, however. Even if the special instrumentality did not qualify as a "governmental unit," it could still seek "exempt person" status under Section 501(c)(3) (see page 21 above), in which case it would be treated for industrial development bond purposes in the same manner as a private nonprofit corporation.

If there is a long-term management contract, bond proceeds would also be used in the trade or business of the management company, and principal and interest payments would be provided from that trade or business. If the management contract is of short duration (such as one year at a time), or if the manager's compensation does not exceed 25 percent of net revenues, the management contract should not by itself constitute the use of a major portion of the bond proceeds in the manager's business. But a ruling would be advisable except on a "small issue." Unfortunately, a manager will not be willing to guarantee the financing with only a short-term contract, and, in that case at least, the marketability of revenue bonds will depend entirely on reliable and favorable revenue projections.

The assignment of a number of channels to commercial broadcasts might constitute the indirect use of a portion of the bond proceeds by the broadcast operators or their advertising sponsors. FCC rules *require* cable television systems to carry certain commercial broadcasts signals on request of the station licensees.[13] Limited provision is also made to exclude duplication of signals so carried.[14] These provisions are in the interests of the station

12. Regulation. §§ 1.103-1 and 1.103-7(b)(2).

13. 47 CFR §§76.57(a), 76.59(a), 76.61(a), 76.63(a).

14. 47 CFR §§76.91-76.159.

licensees. Carrying their signals might, therefore, be regarded as a use by them of the cable system for industrial development bond purposes. However, in the absence of payments by the station licensees to the cable operator,[15] payment of the bonds would not be derived from the trade or business of the commercial stations. Accordingly, carrying commercial signals should not cause the bonds to be "industrial development bonds."

In summary, either ownership by a nonexempt, private corporation or a long-term management contract (with a manager interest in excess of 25 percent) would cause the bonds to be taxable as industrial development bonds unless they qualify for the "small issue" exemption; this will be discussed below.

"Small Issue" Exemption

There are two "small issue" exemptions—one in the amount of $1 million and the other in the amount of $5 million.[16] Essentially, the $1 million exemption can be used on a project of any size, whereas the $5 million exemption cannot be used on a project costing more than $5 million. The $1 million and $5 million exemptions are mutually exclusive in that they cannot be added together. Two or more issues for the same cable system would be added together for the purposes of either the $1 million or the $5 million exemption.[17]

Either exemption is available only if "substantially all of the proceeds" are to be used to finance "land or property of a character subject to the allowance for depreciation."[18] Thus, not more than 10 percent of the net proceeds (after expenses of issue) can be used to provide working capital.[19] Since the early operating years of the system are likely to be loss years, substantial working capital is probably needed, but anything beyond the 10 percent limit will have to come from other sources, such as grants or a contribution by a management company. The financial problems of the early years can also be abated somewhat by deferring principal payments for several years.

The $5 million exemption is available only if aggregate capital expenditures (including but not limited to the bond issue) do not exceed $5 million during the six-year period beginning three years

15. Cf. Teleprompter Corp. v. Columbia Broadcasting System, 415 U.S. 394 (1974).

16. Internal Revenue Code, § 103(c)(6)(A) and (D).

17. Internal Revenue Code, § 103(c)(6)(B).

18. Internal Revenue Code, § 103(c)(6)(A).

19. Regulations, §§ 1.103-8(a)(6) (example), 1.103-10(b)(1)(ii) and (f) (example 6).

prior to the date of issue of the bonds and ending three years after.[20]

The capital expenditures taken into account are those paid or incurred for facilities located in the same incorporated municipality (or in an unincorporated place within the same county if the cable system is located in an unincorporated place)[21] which are principally used by the "principal users" of the cable system.[22] These capital expenditures are *not* limited to expenditures for CATV facilities. When tax exemption is lost by reason of expenditures after the date of issue, only the subsequent interest is taxable.[23]

Bonds are, in fact, issued under the $5 million exemption notwithstanding that interest may subsequently become taxable by reason of unforeseen capital expenditures. It is industry practice to provide for either an increased interest rate or mandatory redemption of the bonds if the interest becomes taxable.[24]

The regulations are not clear, but it appears likely that the "principal users" of the system (those whose expenditures would count in addition to the CATV system cost) would not include any "exempt person" except in respect to an "unrelated trade or business" and would not include the subscribers or the stations whose signals are carried, or their advertisers, or any educational, municipal, or other institutions that are given access to program origination facilities.[25]

Thus, the "principal users" should be limited to the sponsoring nonprofit corporation (if a "nonexempt person" or an "exempt person" carrying on an "unrelated trade or business"), or the sponsoring special governmental instrumentality (if not a "governmental unit"), and the manager (if there is a management contract), but not a sponsoring city.

Where there are several "principal users," it appears that their capital expenditures must be added together.[26] The capital expenditures of "related persons" must also be counted.[27] "Related persons" would include major stockholders of the management company (if any).[28] (It is believed that the interconnection of systems located in the same city, which are owned and sponsored by

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20. Internal Revenue Code, § 103(c)(6)(D).
21. Internal Revenue Code, § 103(c)(6)(E)(i); Regulations, § 1.103-10(f) (example 5).
22. Internal Revenue Code, § 103(c)(6)(E)(ii).
23. Internal Revenue Code, § 103(c)(6)(G).
24. See Regulations, § 1.103-10(f) (example 9).
25. Cf. Regulations, § 1.103-10(b)(2)(ii), (iii) and (iv)(a) and § 1.103-11(b).
26. Regulations, § 1.103-10(b)(2)(vi)(a), (b)(2), (b)(4) and (c).
27. Internal Revenue Code, § 103(c)(6)(E)(ii).
28. Internal Revenue Code, §§ 103(c)(6)(C)(i), 267(b).

Chapter 5

Limited Partnership

Limited partnerships have been an important tool in the financing of housing in the United States. High-bracket limited partners have made substantial capital contributions—partially in exchange for significant tax benefits—thus reducing the costs to developers and tenants. These tax benefits have included the right to use the partnership's investment tax credit on their individual returns and to deduct their shares of partnership "losses." They have been permitted to deduct amounts exceeding their capital contributions (by adding to their "bases" their shares of "nonrecourse" debt, that is, partnership debt on which no partner is liable). Partnership "losses" have been enlarged for tax purposes by accelerated depreciation. Limited partnerships have stretched tax planning still further by allocating large shares to high-bracket limited partners during the early "loss" years and smaller shares to them during the later "profit" years after initial "losses" have been recovered. Legislation has been proposed, however, to limit the tax benefits of limited partnerships.

The assumed model for the purposes of this paper is a limited partnership in which a nonprofit corporation, a special governmental instrumentality, or the city, would act as general partner, and high-bracket taxpayers would be limited partners. The limited partnership would own the CATV system. This arrangement may be precluded in the case of a city because it may be unwise to subject a city to unlimited liability as general partner. In Massachusetts, it might violate the 46th Amendment to the Massachusetts Constitution, and in other states it might violate other comparable constitutional provisions. Accordingly, in the balance of this discussion, it is assumed that the general partner would be a nonprofit corporation or special governmental instrumentality.

For a number of reasons, to be discussed below, the limited partnership is less advantageous in conjunction with the proposed tax-exempt bonds for CATV than in the housing field.

entirely different parties and managed by different managers, would not require that expenditures on the two systems be added together in applying the $5 million limit.)

Summary of Conclusions Regarding Exemption of Bond Interest

1. If a nonprofit corporation owns the system (Alternative A) and there is no management contract providing for a manager interest in excess of 25 percent (and no limited partnership), and if the nonprofit corporation establishes that it is exempt under Section 501(c)(3) and that its revenues are not "unrelated business income," the system can be financed by tax-exempt bonds issued under appropriate legislation by the city or by the nonprofit corporation, regardless of the size of the project.

If the nonprofit corporation fails to obtain exemption under Section 501(c)(3), or if its revenues constitute "unrelated business income," or if there is a management contract with a manager interest in excess of 25 percent (or a limited partnership), the system can be financed by tax-exempt bonds only up to $1 million, or up to $5 million if the cost of the system (including improvements within three years after the bond issue) is less than $5 million.

2. If a special governmental instrumentality is created to own the system (Alternative B), and there is no management contract with a manager interest in excess of 25 percent (and no limited partnership), the system can probably be financed by tax-exempt bonds issued by the city or by the special instrumentality, regardless of the size of the project.

Here again, if there is a more than 25 percent manager interest in the system (or a limited partnership), the bonds can be tax-exempt only up to $1 million, or up to $5 million if the cost of the system is less than $5 million.

3. If the city is to own the system (Alternative C) without a contract providing a manager interest in excess of 25 percent (and without a limited partnership), the system can be financed by tax-exempt bonds issued by the city, regardless of the size of the project.

Once more, if there is a more than 25 percent manager interest (or a limited partnership), the bonds will be tax-exempt only up to $1 million or up to $5 million if the system cost is less than $5 million.

In general, the exemption of bonds issued by a city or special governmental instrumentality is more secure than that in the case of bonds issued by a private nonprofit corporation.

Chapter 5

Limited Partnership

Limited partnerships have been an important tool in the financing of housing in the United States. High-bracket limited partners have made substantial capital contributions—partially in exchange for significant tax benefits—thus reducing the costs to developers and tenants. These tax benefits have included the right to use the partnership's investment tax credit on their individual returns and to deduct their shares of partnership "losses." They have been permitted to deduct amounts exceeding their capital contributions (by adding to their "bases" their shares of "nonrecourse" debt, that is, partnership debt on which no partner is liable). Partnership "losses" have been enlarged for tax purposes by accelerated depreciation. Limited partnerships have stretched tax planning still further by allocating large shares to high-bracket limited partners during the early "loss" years and smaller shares to them during the later "profit" years after initial "losses" have been recovered. Legislation has been proposed, however, to limit the tax benefits of limited partnerships.

The assumed model for the purposes of this paper is a limited partnership in which a nonprofit corporation, a special governmental instrumentality, or the city, would act as general partner, and high-bracket taxpayers would be limited partners. The limited partnership would own the CATV system. This arrangement may be precluded in the case of a city because it may be unwise to subject a city to unlimited liability as general partner. In Massachusetts, it might violate the 46th Amendment to the Massachusetts Constitution, and in other states it might violate other comparable constitutional provisions. Accordingly, in the balance of this discussion, it is assumed that the general partner would be a nonprofit corporation or special governmental instrumentality.

For a number of reasons, to be discussed below, the limited partnership is less advantageous in conjunction with the proposed tax-exempt bonds for CATV than in the housing field.

Net Worth Test

The general partner must have a "net worth" at all times, outside of the partnership, equal to at least 10 percent of the total capital contributions to the partnership (or up to 15 percent in some cases).[1] In some cases this test may be hard to meet.

"Nonrecourse" Loan Problem

The deductions of the limited partners cannot be increased beyond their capital contributions (as is ordinarily done) by adding "nonrecourse" partnership debt to their bases if the "nonrecourse" debt is debt owed to the general partner.[2] Accordingly, if a nonprofit corporation or special governmental instrumentality is the general partner, it cannot advantageously issue the bonds and loan the bond proceeds to the partnership. Even if the city issued the bonds and loaned the proceeds to the partnership, the same unfavorable result might be reached on the ground that the general partner is the alter ego of the city—a not unlikely conclusion if the nonprofit corporation or special instrumentality is established by the city or if its assets would pass to the city on payment of the bonds or on termination of its existence (see pages 26 and 27 above).

Investment Tax Credit

The investment tax credit might be contested on the ground that the credit is unavailable for property "used by" an exempt organization or governmental unit.[3] For other purposes, property used by a partnership is treated as used by each partner.[4] It is believed, however, that this rule should not apply, and that the property should not be treated for this purpose as "used" by each partner. The regulations state that property eligible for the investment tax credit "shall not, by reason of each partner taking his share of the basis or cost into account, lose its character" as eligible property.[5] The correct answer should be that a taxable partner does not lose his share of the credit merely because another partner is an exempt organization or governmental unit.

The credit is temporarily 10 percent but would normally be limited to 4 percent (as opposed to the usual 7 percent), since CATV

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1. Rev. Proc. 72-13, 1972-1 C.B. 735.
2. Rev. Rul. 72-135, 1972-1 C.B. 200; see also Rev. Proc. 74-17, § 3.03, 1974-1 C.B. 438.
3. Internal Revenue Code, § 48(a)(4) and (5).
4. Regulations, § 1.48-3(a)(2)(ii). Contra: Moradian, 53 T.C. 207 (1969).
5. Regulations, § 1.46-3(f)(1).

rates must be subject to regulation, and may be disallowed if the credit is used to reduce rates.[6] The credit may also be disallowed if the management contract amounts in substance to a lease.[7]

Tax Problems on Sale of Partnership Property

If the partnership property is not eventually sold, the paper losses deducted by the partners in the early years are likely to be followed by paper profits taxable as ordinary income in the later years. Accordingly, it is often assumed that the partnership property will be sold at an appropriate time so that the limited partners' gains will be largely capital gains. In a housing partnership, a declining portion of the gain is taxed as ordinary income, but that portion cannot exceed the depreciation taken in excess of straight-line depreciation.[8] On the sale of a cable system the limited partners would pay an ordinary income tax on their shares of all the depreciation taken.[9] This could make a very substantial financial difference.

If the cable system is to be sold, it should probably be sold to the general partner or to the city in order to achieve permanently the public advantages intended to be accomplished. In order to permit this to occur, the partnership share of the general partner at the time of the sale should not exceed 80 percent. Otherwise, the limited partners are likely to pay ordinary income taxes on their shares of the entire gains.[10]

In any event, the general partner (or the city) should not be given an option to purchase the system at anything substantially less than market value. Such an option would, in effect, reduce the residual shares of the limited partners to zero and might cast doubt on the reality of the entire partnership arrangement. The granting of such an option to the city would also mean that the "nonrecourse" loan problem could not be solved by having the city issue the bonds and lend the proceeds to the partnership (see page 34 above),[11] because in such a case the city would be treated as if it were a general partner.

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6. Internal Revenue Code, § 46(a)(1)(A), (c)(3) and (f); 47 CFR § 76.31(a)(4).

7. Internal Revenue Code, § 46(e)(3). See also § 163(d) as to partial disallowance of interest deductions.

8. Internal Revenue Code, § 1250.

9. Internal Revenue Code, § 1245.

10. Internal Revenue Code, § 707(b)(2)(A).

11. Rev. Rul. 72-350, 1972-2 C.B. 394.

Industrial Development Bond Treatment

A limited partnership would be a nonexempt "person."[12] Therefore, the use of a limited partnership would preclude the issue of more than $1 million tax-exempt bonds for a system costing more than $5 million (see Chapter 4 above). There is a special exemption for housing bonds (of any amount) from IDB treatment, but this exemption is not available for CATV bonds.[13]

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12. Internal Revenue Code, §§ 103(c)(2)(A) and (3)(B), 7701(a)(1).
13. Internal Revenue Code, § 103(c)(4)(A).

Chapter 6

Contributions and Grants

Deductibility of Contributions by Individuals and Corporations

Contributions to Nonprofit Corporation

Individuals and business corporations may deduct contributions to private nonprofit corporations that have exempt status under Section 501(c)(3) of the Internal Revenue Code.[1] But as explained above in Chapter 3 of this paper the exempt status of a nonprofit CATV corporation under Section 501(c)(3) is doubtful. Accordingly, no assurance can be given that the contributions would be deductible.

If the contributions of individuals were deductible, they would be among those limited to 20 percent of adjusted gross income unless certain complex factual tests are satisfied, in which event the contributions would be among those subject to a 50 percent limit instead of the 20 percent limit.[2]

Contributions to Special Governmental Instrumentality

Contributions to a "political subdivision . . . for exclusively public purposes" are deductible.[3] If the CATV owner is a special governmental instrumentality, its status as a "political subdivision" is doubtful (see page 22 above). It is also not clear that CATV is an "exclusively public" purpose. Accordingly, it is uncertain whether contributions by individuals and business corporations would be

1. Internal Revenue Code, § 170(c)(2).
2. Internal Revenue Code, § 170(b)(1)(A)(vi), (vii) and (viii).
3. Internal Revenue Code, § 170(c)(1).

deductible. In the case of an individual, the contributions (if deductible) would be subject to the 50 percent limit rather than the 20 percent limit.[4]

If contributions failed to qualify as gifts to a "political subdivision . . . for exclusively public purposes," the instrumentality could seek exempt status under Section 501(c)(3), in which case its prospects for deductible contributions would be the same as those of a private nonprofit corporation.

Contributions to City

If the city is the CATV owner, contributions by individuals and business corporations would be deductible if the purpose is recognized as "exclusively public."[5] But since the "exclusively public" nature of CATV is uncertain, an IRS ruling would be desirable. Here again, the contributions of individuals (if deductible) would be subject to the 50 percent limit rather than the 20 percent limit.[6]

Eligibility for Foundation Grants

Grants to Private Nonprofit Corporation

Private foundations are subjected to a 100 percent tax on income not used for "qualifying distributions."[7] Pursuant to Section 4942(g)(1), if the nonprofit CATV corporation has exempt status under Section 501(c)(3) (see Chapter 3), it can be the recipient of "qualifying distributions," but only if:

1. It normally receives a substantial part of its support from government or contributions by the general public;[8]

2. It normally receives more than one-third of its support from government grants, small contributions, dues, and services fees (which may not be the case if net income is realized from fees paid to receive commercial broadcasts, because such net income may be attributed to an "unrelated business," as discussed in Chapter 3, and net income from an unrelated business does not qualify in meeting this test);[9] or

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4. Internal Revenue Code, § 170(b)(1)(A)(v).
5. Internal Revenue Code, § 170(c)(1).
6. Internal Revenue Code, § 170(b)(1)(A)(v).
7. Internal Revenue Code, § 4942.
8. Internal Revenue Code, §§ 509(a)(1) and 170(b)(1)(A)(vi).
9. Internal Revenue Code, § 509(a)(2), 4946 and 507(d)(2).

3. It expends its income currently or sets it aside with the approval of the Commissioner of Internal Revenue.[10]

These tests have been oversimplified here. It is sufficient to say that a private foundation would want detailed evidence of compliance before making grants to a nonprofit CATV corporation.

Grants to Special Government Instrumentality

Since the status of a special governmental instrumentality as a "political subdivision" would be doubtful (see page 22 above), the instrumentality might have to seek exempt status under Section 501(c)(3) on the same basis as a private corporation, and if exempt status were obtained, eligibility for foundation grants would turn on the same tests set forth above for a private nonprofit corporation.[11]

Grants to City

If the city owns a CATV system, it would be eligible as a "political subdivision" to receive "qualifying distributions" from private foundations if the CATV operation is recognized by the IRS as "charitable, scientific, literary or educational."[12] It is not clear that CATV would be treated as "charitable, scientific, literary or educational" (see Chapter 3 above).

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10. Internal Revenue Code, §4942(j)(3) and (g)(2) and (3).

11. See Internal Revenue Code, §§4942(g)(1), 509(a)(1) and 170(b)(1)(A)(v) and (c)(1).

12. Internal Revenue Code, §§4942(g)(1), 509(a)(1) and 170(b)(1)(A)(v) and (c)(2)(B).

Chapter 7

Massachusetts Statutes

The pertinent statutes consist of the Massachusetts nonprofit corporation law, the Massachusetts CATV law, and the Massachusetts tax laws.

Massachusetts Nonprofit Corporation Law

A nonprofit corporation may be organized in Massachusetts for, among others, "any civic, educational, charitable, benevolent or religious purpose," or "any antiquarian, historical, literary, scientific, medical, chiropractic, artistic, monumental or musical purpose."[1] It is not entirely clear that these purposes include community cable television.

If so specified in its articles of organization, a nonprofit corporation may borrow and lend money and be a member of a partnership.[2] But no provision is made for the establishment of such nonprofit corporations as governmental instrumentalities and no provision is made for them to issue tax-exempt bonds "on behalf of" any city or town as discussed in Chapter 4.

Massachusetts CATV Law

City or Town System

A city or town may construct, purchase or lease, and operate a CATV system.[3] To finance such a system a city or town may issue

1. Mass. G.L. c.180 §4(a) and (b).
2. Mass. G.L. c.180 §6; c.156B §§9(h) and (i) and 9A.
3. Mass. G.L. c.164 §34 and c.166A §20; see also c.4 §7(34).

general obligation bonds (bonds payable from all funds of the city or town) within certain debt limitations.[4]

No provision is made for a city or town to issue revenue bonds (bonds payable solely from CATV revenues), or to establish a special governmental instrumentality to own or finance a cable system, or to authorize a nonprofit corporation to borrow on its behalf.

Regulatory Provisions

The franchising authority is the city or town.[5] The license is nonexclusive and may run for not more than 15 years; renewals are limited to 10 years each.[6]

It may be appropriate to permit an exclusive franchise for public CATV. Also, if a borrowing is to run for more than 15 years, it may be appropriate to provide a longer license period; if additional bonds are to be issued for improvements after a license has been granted, provision should be made for extension or renewal of licenses prior to their expiration. The FCC believes, however, that 15 years is generally long enough.[7]

There are additional requirements: Cable drops and outlets must be provided for public schools, police and fire stations, public libraries, and other designated public buildings;[8] provision is made for "equal opportunities" for political broadcasts;[9] service must be extended to at least 10 percent of the service area each year and to the entire service area within 6 years;[10] and competition among applicants must be permitted.[11] The FCC "expect[s]" the franchising authority to invite competitive applications.[12]

The application fee is $100, and there are annual fees to the city or town and to the state of 50 cents to each per subscriber, but not less than $250 to each.[13] Under FCC rules, the annual fee should be in the range of 3 to 5 percent of subscription revenues and cannot exceed 3 percent without FCC approval.[14]

4. Mass. G.L. c.44 §8(8) and (8A).
5. Mass. G.L. c.166A §§1(d) and 3.
6. Mass. G.L. c.166A §§3 and 13.
7. 37 Fed. Reg. 3276, par. 182 (February 12, 1972).
8. Mass. G.L. c.166A §5(e).
9. Mass. G.L. c.166A §5(j).
10. Mass. G.L. c.166A §5(m) and (n).
11. Mass. G.L. c.166A §6.
12. 37 Fed. Reg. 3276, par. 178 (February 12, 1972).
13. Mass. G.L. c.166A §9.
14. 47 CFR §76.31(b).

The license may be revoked for cause by the city or town or by the state CATV commission,[15] or can be transferred (with approval of the city or town as franchising authority), but not for "a substantial payment."[16] This requirement of approval of a transfer may be inconsistent with the transfer to the city required by Revenue Ruling 63-20 (1963-1 C.B. 24, 25), wherein tax-exempt bonds are issued by a private nonprofit corporation "on behalf of" the city (see page 26 above).

Subscriber rates are subject to state regulation after November 16, 1974.[17] Previously, the city or town could regulate rates, provided that they could not exceed $7 per month.[18] Under FCC rules, the initial rates and any increases must be subject to approval by the franchising authority, that is, the city or town.[19]

Moreover, the commission may promulgate "standards."[20] No express provision is made relating to management contracts, but the commission could require their terms to be set forth as "other information" in the application form prescribed by the commission.[21] Note, however, that the license itself is issued by the city or town without the approval of the state commission.

In the case of a city or town system, confusion exists whether CATV would be subject to the provisions of law applicable to municipal electric departments as well as to the CATV law, since the most recent enabling legislation refers to constructing and operating a CATV system "in accordance with this chapter" (the chapter on gas and electricity).[22]

Massachusetts Tax Laws

Local Property Taxes

Real and personal property are generally subject to local property taxes.[23] If the CATV facilities are to be owned directly by

15. Mass. G.L. c.166A §§11 and 14.
16. Mass. G.L. c. 166A §7.
17. Mass. G.L. c.166A §15.
18. Mass. St. 1971 c.1103 §2.
19. 47 CFR §76.31(a)(4).
20. Mass. G.L. c.166A §16.
21. Mass. G.L. c.166A §4.
22. Mass. G. L. c.164 §34 as amended by St. 1973 c.933 §1.
23. Mass. G.L. c.59 §2.

the city or town, or by a special governmental instrumentality, they are probably implicitly exempt from local property taxes.[24]

If the facilities are to be owned by a private nonprofit corporation, exemption as property of "a literary, benevolent, charitable or scientific institution" appears doubtful.[25]

If the facilities are owned by a limited partnership, the real estate is taxable, but the limited partners' shares of the studio equipment and cable may be exempt as property subject to personal income taxes.[26] In any event, the limited partners (whether resident or nonresident) would pay Massachusetts personal income taxes on their income shares.[27]

For comparison purposes, a business corporation owning CATV facilities would be subject to local property taxes on the real estate and cable (as "wires") and perhaps on the studio equipment (as "machinery").[28]

There is an overriding exemption from local taxes for 75 percent of the value of cable required by local bylaw or ordinance to be placed underground, but that value (together with any studio equipment not constituting "machinery") would be taxed by the state at $7 per $1,000.[29]

Corporate Franchise Taxes

A corporation formed under the Massachusetts nonprofit corporation law is subject to the state corporation tax as a "business corporation" unless it is exempt from federal income taxes under Section 501 of the Internal Revenue Code.[30] The tax is measured in part by net income (essentially federal net income) and in part by property or net worth.[31]

Conclusions Regarding Need for Enabling Legislation

If a private nonprofit corporation is to be used, enabling legislation would be needed:

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24. See Cabot v. Assessors of Boston, 335 Mass. 53, 59-60, 138 N.E. 2d 618, 622-623 (1956).

25. Mass. G.L. c.59 §5(3rd).

26. Mass. G.L. c.59 §5 (27th) and c.62 §17; cf. Vance, Sanders & Co. v. State Tax Commission, 350 Mass. 536, 215 N.E. 2d 890 (1966); but see: G.L. c.59 §18 (6th).

27. Mass. G.L. c.62 §17.

28. Mass. G.L. c.59 §5 (16th).

29. Mass. G.L. c.59 §5 (16th) (1A) and c.63 §§30, 32 and 39.

30. Mass. G.L. c.63 §30(1).

31. Mass. G.L. c.63 §32.

1. to confirm that nonprofit corporations may be organized under the Massachusetts nonprofit corporation law for CATV purposes;

2. to confirm that they may issue bonds "on behalf of" cities and towns (that is, that cities and towns can enter into the arrangements required by Revenue Ruling 63-20 [see page 25 above]), including transfer of the system to the city or town when the bonds are paid off;

3. to confirm the exemption of the nonprofit corporation from local property taxes and state corporation taxes; and

4. to authorize management contracts, set the standards therefor, and to establish an administrative procedure for making final determinations that the arrangement serves a public purpose (see Chapter 1 above).

If a special single-purpose governmental instrumentality is to be the system-owner, enabling legislation would be needed:

1. to provide for the establishment of such an instrumentality with the approval of the city or town; to provide for the appointment or election of its governing body; to confirm its exemption from state and local taxes; and to provide for transfer of its assets to the city or town in the event of its dissolution, all in accordance with Revenue Rulings 57-187 and 60-248 (see pages 26 and 27 above); and

2. to authorize management contracts, set the standards therefor and establish a binding procedure for determining public purpose.

If a city department is to be used, the enabling legislation would supplement the existing CATV law:

1. to authorize the city to issue revenue bonds for the system;

2. to resolve the confusion as to whether a city-owned system is subject to the rate provisions which apply to a municipal electric department;

3. to confirm exemption of the city's CATV operation from state and local taxes; and

4. to authorize management contracts, set standards for them, and establish a procedure for determining public purpose.

Perhaps some of the above could be accomplished by a local ordinance or bylaw without new legislation at the state level. A Massachusetts city or town may exercise by local bylaw or ordinance any power which the General Court (that is, the legislature) could confer upon it, but this does not permit a city or town to exercise a power which is "inconsistent with . . . laws enacted by the general court" or "to levy . . . taxes" or "to borrow money or pledge the credit of the city or town."[32] (Revenue bonds are not considered

32. Mass. Const., 2nd Amendment as amended by 89th Amendment (the "Home Rule Amendment"), §§6 and 7(3).

debt in most states because of the "special fund doctrine.")[33]

Nevertheless, it appears that local action would not suffice. Local action cannot alter the general corporation laws of the state or create state or local tax exemptions. Moreover, the comprehensive scheme already authorized by law for municipal ownership and operation of CATV facilities and for their financing by general obligation bonds (and without provision for management contracts) may "pre-empt" the field and preclude municipal involvement in CATV operation on any other basis without the enactment of further legislation by the state legislature.[34]

Appendix A outlines enabling legislation for the ownership of CATV facilities by the city or town, control by a special administrative board, and financing by revenue bonds.

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33. Rhyne, Municipal Law, National Institute of Municipal Law Officers (1957), par. 14-7, pp. 334-335.

34. See Bloom v. Worcester, 1973 Mass. A.S. 291, 293 N.E. 2d 268 (1973).

Appendix A

Outline of Enabling Legislation*

1. Legislative Findings and Declaration of Purpose.

2. Definitions.

3. Formation of CATV Agency. A city or town, acting by its mayor, city manager, or selectmen, may establish a special agency of the city or town for CATV purposes (or assign the CATV function to the existing municipal electric department). The special agency would not constitute a governmental instrumentality separate from the city or town but would be part of the city or town government. It would be administered, however, by a special governing board.

4. Governing Board. Board membership should be limited to elected or appointed public officials of the city or town, persons appointed by them, persons elected (in accordance with election laws) from the city or town (or from the territorial area to be served by the system), and persons chosen by the foregoing board members.

5. General Powers.

6. Management Contracts. Provision may be made for management contracts for such periods and compensation and including such delegation of powers as are found necessary or desirable to accomplish the objectives referred to in paragraph 18 below, reserving, however, in any case, supervisory control over the assignment of noncommercial channels and program origination.

7. Special CATV Provisions. Length and exclusiveness of franchise, data transmission and other one-way or two-way communication services, interconnections with other systems, use of poles

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**Note:* This outline is based on Massachusetts law. Before it is used in any other state, the existing constitutional, statutory and case law of that state should be carefully reviewed.

and conduits of other utilities,[1] clarify applicability of municipal electric laws, and other special provisions if necessary.

8. Revenue Bonds. Authorization, maturities, redemption provisions and other details.

9. Bond Anticipation Notes.

10. Trust Agreement or Bond Resolution. Provisions for the protection of bondholders and noteholders, pledge of the issuer's CATV revenues. Pledges deemed effective when made and deemed perfected under the Uniform Commercial Code.

11. Limited Obligations. Bonds and notes are to be payable solely from revenues of city from CATV system.

12. Trust Funds. Moneys held or received under act to be treated as in trust for purposes of act.

13. Remedies of Bondholders and Noteholders and Trustee.

14. Tax Exemption. Exempt property, franchise and income from state and local taxes, exempt subscriber fees from sales taxes (if otherwise applicable), exempt bonds and notes, interest thereon and profit made on sale thereof from property and personal income taxes.

15. Investment Securities. Bonds and notes deemed investment securities under Uniform Commercial Code.

16. Legal Investment. Bonds and notes eligible for investment by banks, insurance companies, savings banks, etc. and fiduciaries and eligible for deposit with any governmental agency under provisions for deposit of state bonds.

17. Refunding Bonds.

18. Administrative Approval. If there is to be a management contract, make financing subject to approval by mayor or manager and council, or selectmen, upon finding (with supporting reasons) that public financing will constitute a public use and benefit and facilitate educational, governmental and other public services and that the terms of any management contract are in the public interest and provide no greater compensation or delegation of powers than is necessary to the foregoing objectives. Provide (as to both cities and towns) for an administrative public hearing (before approval) on notice published and sent to the applicant and to utilities whose poles or conduits may be used. (This may be combined with franchise hearing under G.L. c.166A § 6.) Provide a relatively short period (60 to 90 days) for initiation of judicial review after similar notice of the administrative decision.

19. Other Proceedings. Bonds and notes may be issued without any proceedings other than those specifically required by the act.

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1. Cf. Mass. G.L. c.166 § 24.

20. Miscellaneous. Provision may also be made for tort liability (or immunity), civil service (or exemption therefrom) and other matters deemed necessary in the particular state.

21. Interpretation. Liberal interpretation, interpretation to meet constitutional requirements, severability of invalid provisions, powers under this legislation to be supplemental to and not in substitution for powers under other laws.

22. Effective Date.

About the Author

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The Center for Community Economic Development (CCED) is an independent research group located at 639 Massachusetts Avenue, Cambridge, Massachusetts 02139. Its primary function is to conduct public policy research by examining the ongoing problems of community development corporations (CDCs) and of other community-based economic organizations. CDCs and other similar community groups are instituted and controlled by local residents to improve the economy of their home areas. The central aim of these organizations is to increase the participation of their constituents in the nation's economic, social, and political life. R & D activities at CCED are designed to support that goal.

CCED also maintains a library, acts as a clearinghouse for materials and information on community-based economic development, and provides advocacy services related to its research. The work is supported by a grant from the federal Community Services Administration, as well as by other government and private funding sources.

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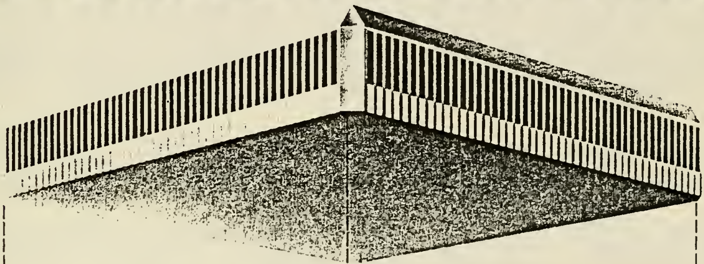
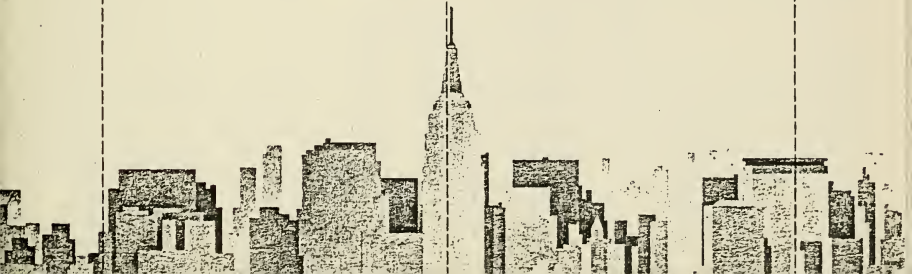
Who's Holding Up Solar Energy? by Andrew Tobias
Why Front-Runners Keep Stumbling, by Richard Reeves
Fanny Pants: Summer's Newest Erogenous Zone

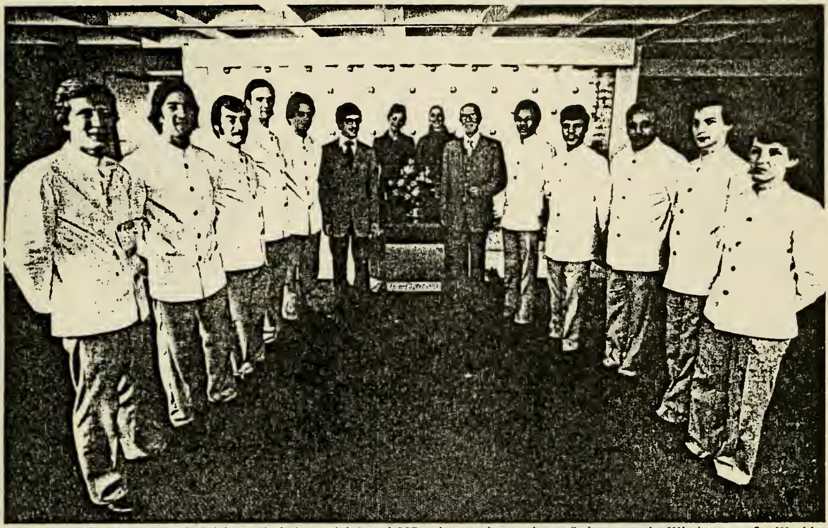
The Most Spectacular Restaurant in the World



How a Brilliant Restaurateur Created a Masterpiece on the 107th Floor Of the World Trade Center

By Gael Greene





Reception: *Concierge Joseph Scialom (sixth from right) and 297 others make up the staff that runs the Windows on the World.*

The Most Spectacular Restaurant in the World

By Gael Greene

"...Windows on the World is a triumph. No other sky-high restaurant quite prepares you for the astonishment of these horizons..."

One minute I was just the everyday me . . . mildly optimistic, sedately enthusiastic, benignly paranoid, wholesomely cynical. And then zonk! Epiphany. A revelation. Suddenly I knew—absolutely *knew*—New York would survive. As Joan of Arc knew she would save France, as St. Theresa knew, and Charles Colson . . . I knew. New York would prevail. Forget about Acapulco gold. This is Manhattan green. If money and power and ego and a passion for perfection could create this extraordinary pleasure . . . this instant landmark, Windows on the World . . . money and power and ego could rescue the city from its ashes. What a high.

But that is what happens on the 107th story of the North Tower of the Port Authority's fiercely despised World Trade Center. Intoxication. A dizzying post-industrial enchantment. Layers of jaded veneer peel away. Every view is brand-new . . . a miracle. In the Statue of Liberty Lounge, the harbor's heroic blue sweep makes you feel like the ruler of some extraordinary universe. All the bridges of Brooklyn and Queens and Staten Island stretch across the restaurant's promenade. Even New Jersey looks good from here. Down below is all of Manhattan and helicopters and clouds. Everything to hate and fear is invisible. Pollution is but a cloud. A fire raging below Washington Square is a dream, silent, almost unreal, though you can see the arc of water licking flame. Default is a silly nightmare. There is no doggy doo. Garbage is an illusion.

From 11:30 in the morning until three, this is The Club at the World Trade Center. Not much of a club, frankly. No squash courts. No tennis. No swimming pool or crisping in the sun. No billiards; so far, no serious gin rummy. Yes, there are showers and a sauna. A masseur is promised, a valet, a resident hairdresser. The concierge will get tickets and reservations. There is a walk-in humidor (empty so far), a library (quite bare), a wine cellar

Photographed by Burt Glinn

"Windows" creator Joe Baum: *Nobody has ever called him less than a genius.*

(members may buy and store their own at 25 percent above cost plus $1.50 per bottle corkage). At heart it is a lunch club, a dazzling stage for that midday ritual where we woo and con each other in tax-deductible splendor.

Anyone can join. No sponsor needed, no pedigree, no old-school tie. Just good credit and money: $360 a year dues for World Trade Center tenants, $420 for downtowners, $100 if you work north of Canal Street, $50 outside the port district. *After* three o'clock the 107th floor is no longer The Club; it becomes Windows on the World, and no one needs a membership. Anyone can stop by for tea or a drink. At three, the lunchtime Grill becomes the gracelessly named Hors d'Oeuvrerie. The public is welcome for an appetizer or two or twenty, drinks, dancing. And dinners in The Restaurant: à la carte, $13.50 table d'hôte, or the grander Monticello dinner for $16 (Thomas Jefferson was one of the country's first gourmands); on weekends, unchecked gluttony at the $9.75 buffet.

One week before the opening, nothing is really ready. The staff is willing but mostly green. The kitchen is shaking down. At this moment the sound is still unbalanced, the lighting not yet choreographed, artworks still arriving, doorknobs missing. And yet Windows on the World is already a triumph. No other sky-high restaurant in New York has quite prepared you for the astonishment of these horizons. Tentative, unproven, still in rehearsal, Windows is the most exciting restaurant in town . . . a spectacular exhibit in the long, tortuous comeback of its creator, Joe Baum.

No one ever suggested that Baum was less than a genius. But Baum himself often seemed bedeviled by doubt. Restaurant Associates' mighty $100-million feeding empire was staggered by the reeling economy of the late sixties. Joe Baum's taste and drive and showmanship, the capacity to terrorize and inspire, to create such feeding smashes as the Four Seasons, the Forum of the Twelve Caesars, Charley O's, the Fountain Café, and Zum Zum were deemed obsolete. Baum was bluntly axed, heavily in debt and near death with peritonitis. Lashed with tubing, he lay in New York Hospital, forbidden to smoke, flicked an ash from his cigar, and said, "Oh well, easy come, easy go."

There was a gloriously excessive wake at Stonehenge Inn and Baum declared himself a restaurant consultant—a security blanket that can mean anything. Even when, in December, 1970, he signed a contract to design the entire feeding system for the World Trade Center at $125,000 a year, it rang of compromise, a comedown, farewell to elastic expense accounts. Sometimes seeing Joe was like spending time with a burn victim—his skin was gone. "He would talk as if he were a man with no success," a friend recalls. "As if success had been ripped out of him." He worked out of the Port Authority's dingy old building on Eighth Avenue . . . its only virtue, proximity to the Trattoria da Alfredo. He seemed mired in endlessly impossible dreams. He would unfold intricate blueprints, describe delicatessens, seafood bars, brasseries, old-fashioned soda fountains, rotisseries, ethnic bazaars selling sake, couscous, scungilli, chitlings, God knows what . . . everything converting at night into retail shops. And a sublime restaurant in the sky.

Years dragged on. Got so you didn't want to ask Joe how things were going.

There were lawsuits and strikes and great outpourings of sheer loathing for the Port Authority's autocracy. All of government's disdain for people seemed to be symbolized in those two outrageously relentless $950-million towers . . . dwarfing their neighbors, glutting the real estate market, taxing the subways, emitting 2 million to 3-million tons of sewage a day, guzzling tons of fresh water, devouring more electricity than Stamford, Connecticut. Inflation. Recession. Construction delays. Endless justification for Baum's plans. Legislative hearings. Blueprints. Revisions.

Suddenly it all came together. So quickly, from wet concrete to dry martinis, even the faithful were astonished.

Lunch, the fifth day after The Club's opening. The North Tower lobby is sheer *2001*. Gothic arches seven stories high . . . purple carpet already fading. The story goes that a student once asked the architect, "O master, why did you build two 100-story buildings instead of one 200-story building?" And he answered, "Ah, to keep the human scale." The velvet-rope keeper expects us. The elevator is one and a half Clint Eastwoods tall, very deep, and very fast—58 seconds for the ascent (62 on a windy day).

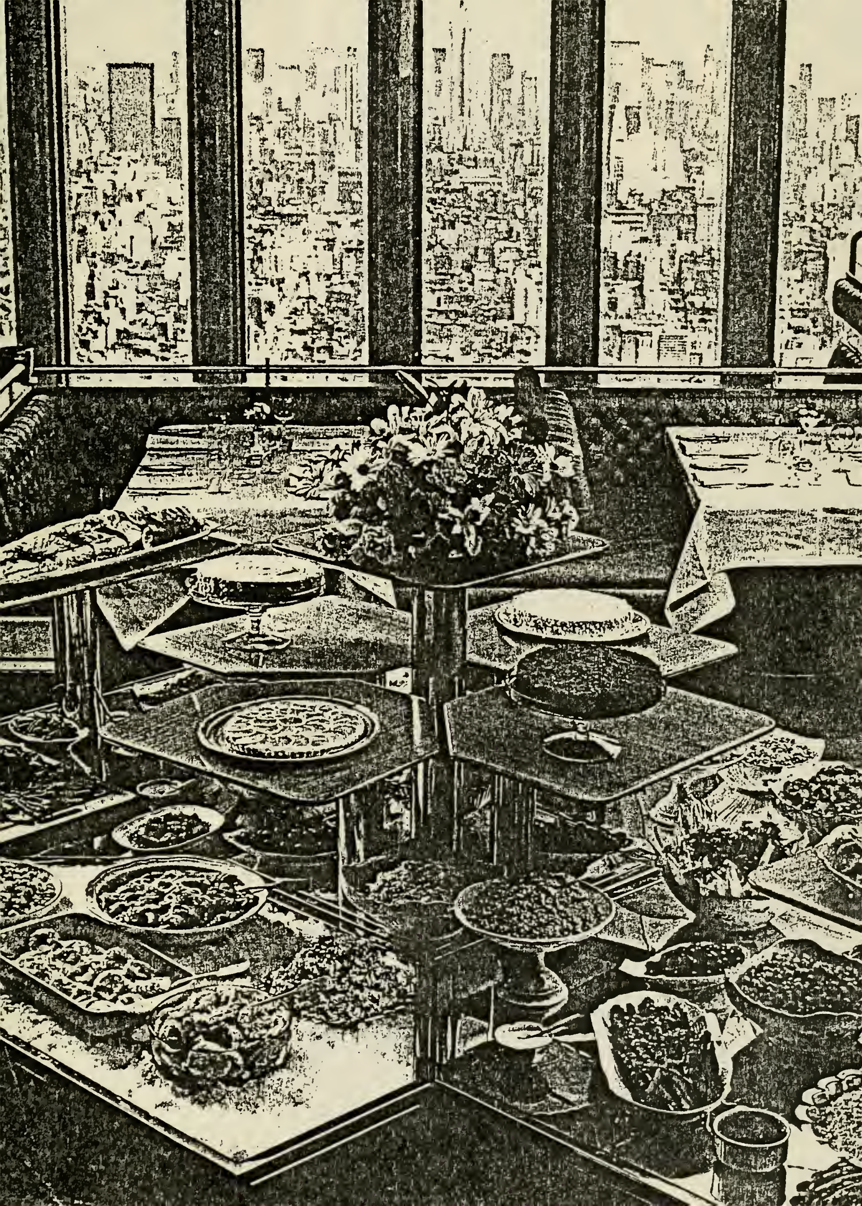
Doors open. Everything is tawny, subtle . . . beige, white, and gold. An army of attendants, pages, hostesses, a concierge. Pamela, a visiting niece from a provincial suburb who starred in my *New York* experiment "How to Introduce a Child to Haute Cuisine" at ten, is sixteen now. "It's like a mental hospital," she whispers. "All those attendants in white coats waiting to sign you in." Pam has just seen *One Flew Over the Cuckoo's Nest*. And she's right. But then Pamela has never sailed first class on the *S.S. France*. And Windows has that feeling too. An extraordinary luxury liner sailing through blue skies 107 stories above the sea. You get the message in the sleek mess uniforms, the epaulets, the gold braid, the brass railings.

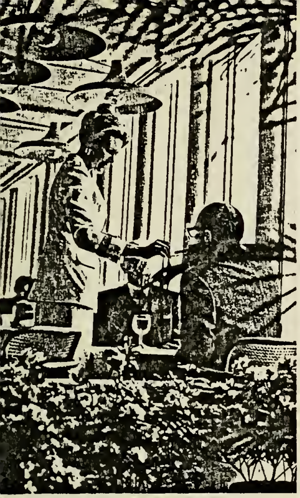
There are familiar faces from the old Restaurant Associates days. Dapper, stylish captains. "Our Satchel Paiges," Baum calls them. And his rookie waiters—fresh and eager, sweetly confused, treading in each other's tracks. The apéritif order is requested twice. Twice the wine is presented for inspection. Twice we are asked if we would like dessert. It scarcely matters. Their spirit is contagious. Pride, joy . . . whatever it is. Unbelievable that the house can function so smoothly on only the fifth day. The food is good. Perhaps someday it will be very good. Perhaps it never will. Unfair to judge so soon. The menu is still evolving. But the desserts are splendid. The Grand Buffet ($2.95 as an appetizer, $7.95 for unlimited exploration) tickles eclectic appetites with bay scallops in seviche, sea bass salad, cold meats and terrines, turkey-apple salad, sesame-dressed Japanese noodles, jambon persillé, herring in dilled mustard, bass in aspic, lentil salad, a daily roast and stew.

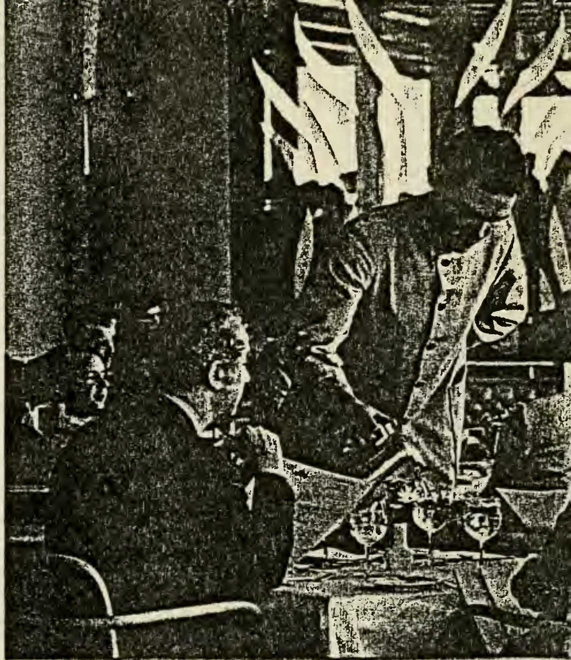
Joe Baum is everywhere. "This is one of my favorite tables," he says. It sounds like a post-hypnotic suggestion. We are as far as we can be from the window. Yet the view is remarkable. "I don't ever want to be in the position of selling window seats," Joe says.

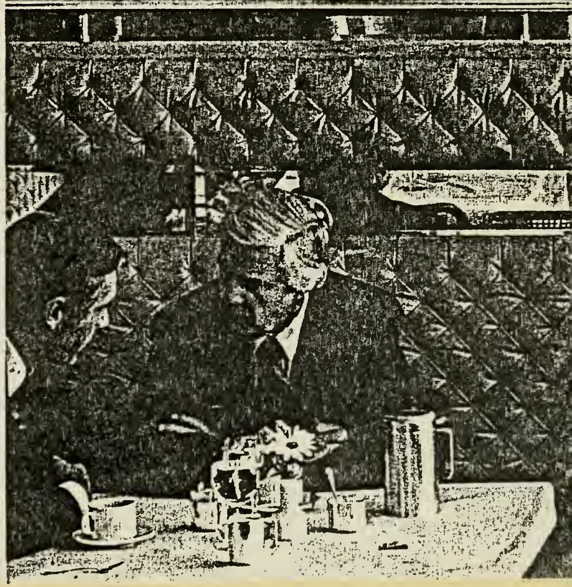
Changeable Feasts

Dishes on the Grand Buffet table in The Restaurant change every day. Eat all you want for $7.95 on weekdays; weekends, the spread ($9.75) is even more elaborate.









The Restaurant

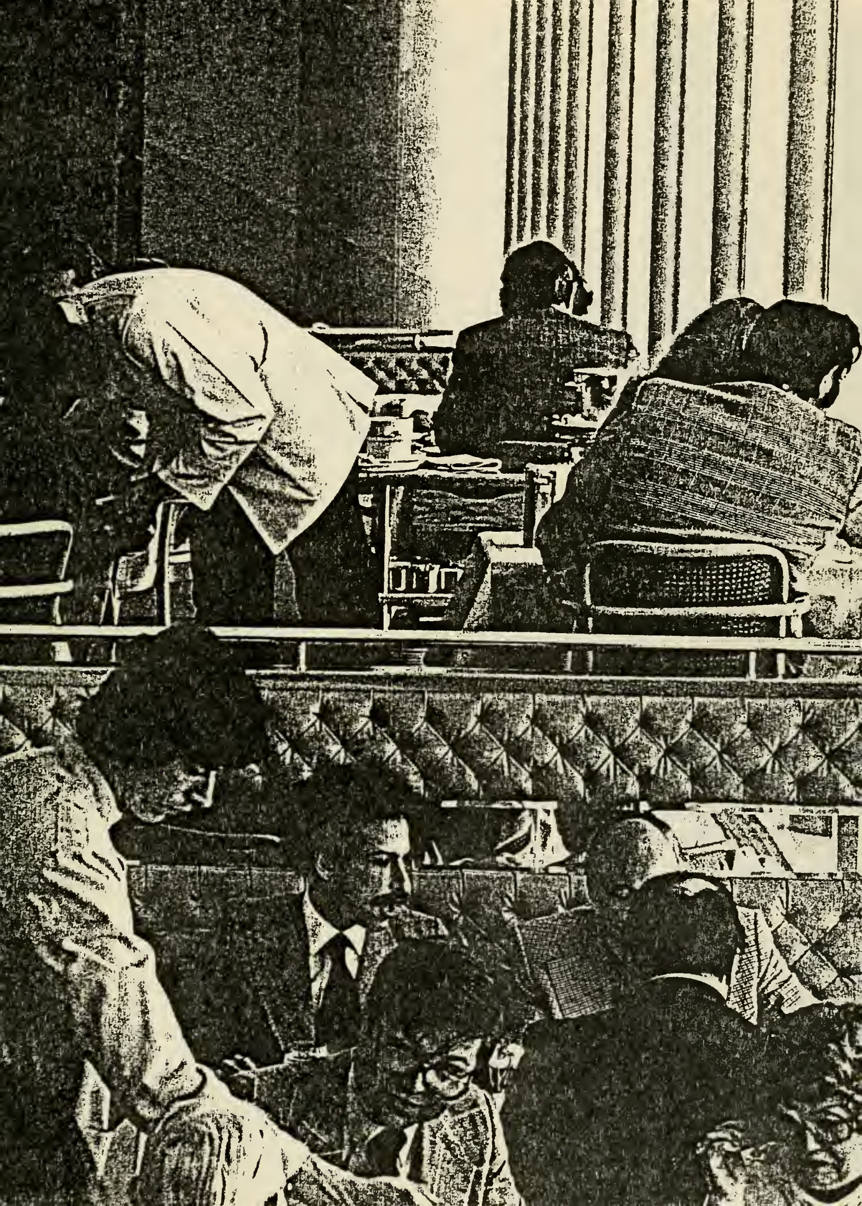
Service captain is not a "men-only" job at Windows on the World. Above, Claudette Fournier in The Restaurant. The ingenious use of platforms and mirrors there, Joe Baum hopes, will obviate the hassle for tables near the windows.

"They didn't put enough sugared pecans on your strawberry-rhubarb compote," he complains, pounding the table, about to summon a waiter.

"No, Joe. They did. I ate them."

Joe Baum is a small man, but he can walk tall—tall and mean. Workmen may not know who he is, but they sense he is . . . somebody. "The warp on that hemp mat goes the wrong way," he observes. "They'll have to re-lay it." He bends down to pick up a cigarette wrapper and an ashtray someone has kicked into a corner. "There is nothing in the place that does not have his mark on it," observes Milton Glaser, graphics designer of Baum's dream. "Every word has been filtered through him—should it be tartar steak or steak tartare?" Baum's longtime menu printer, Bill Doerfler, agrees: "Menus may go through eleven revisions, but by the time they come to me, that's it. He's a pleasure to work with if you know your business. If you don't, you have a problem."

"This is the kitchen," says Baum proudly. "Isn't it beautiful?" You can see he is itching to straighten up the ravaged cracker-supply counter. "No table is more than twenty steps from the kitchen," he boasts. At the far end hangs a sign: PASTRY GENIUS. Albert Kumin, the Swiss pastry master from the golden days of Baum's reign at



the Four Seasons, is on loan from the Culinary Institute of America (CIA), hiring bakers, setting up the commissary bakeshop, perfecting his achingly piquant lemon tart. A tall blonde with Campbell Kid curls works beside him. The entire staff is an emancipator's dream—male and female, assorted colors, eclectic backgrounds.

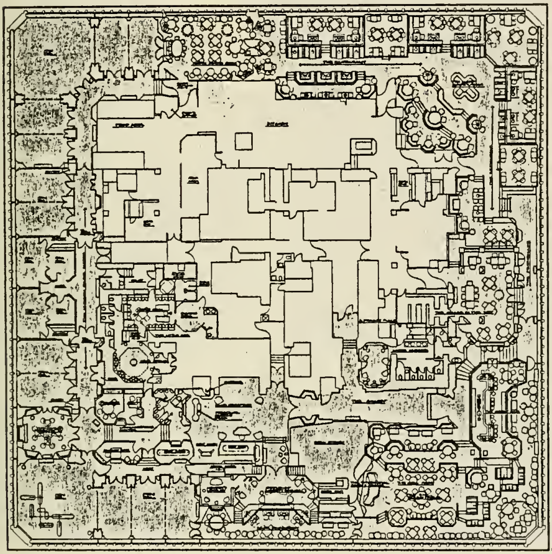
"Oh God, I hope it will be good," says Joe.

The Club is the showpiece of a com-

The Plan

Below, one of the working drawings used in planning the 107th floor. The shaded areas on the perimeter are the public spaces. The core contains the work spaces and building services.

210 ft.



munity of WTC restaurants and carry-outs designed to feed the complex's 50,000 employees, 80,000 visitors . . . 30,000 lunches a day, mostly $2 or less, in 35 locations. It was early deemed impractical to parcel out parts of Baum's feeding scheme to individual owners. A tribe of operators would quickly tax truck docks, elevators, and garbage disposal. But when WTC director Guy Tozzoli presented Baum's plan and construction estimate to food industry giants, no one was interested. "I hadn't planned to spend a dime building The Club," Tozzoli recalls. "Everyone thought Joe's plan was brilliant but they weren't willing to make the capital investment." So $21 million was budgeted for creating food service. (The Club itself is only $300,000 to $400,000 over its $7.5-million budget, Tozzoli reports.) Now nine companies were interested enough to bid, Joe Baum among them. But Hilton International's bid offered the most profitable balance for the Port Authority. It didn't require exceptional intelligence for H. I. president Curt Strand to form Inhilco to run the system with his old Cornell Hotel and Restaurant School classmate Joe Baum as president. Same salary plus a percentage. Net profits go 85 percent to WTC, 15 percent to Inhilco.

"Tozzoli is a feisty guy with a good eye," says Baum. "He gets things done. He protected the integrity of our idea. Ask him how the windows got wider."

"The steel was going on, already 40 stories up," Tozzoli recalls. "And I saw how thick the mullions were and I realized we were building a view restaurant with a limited view. I called our architect, Yamasaki, and he refused to change it." Tozzoli built a win-

The Grill

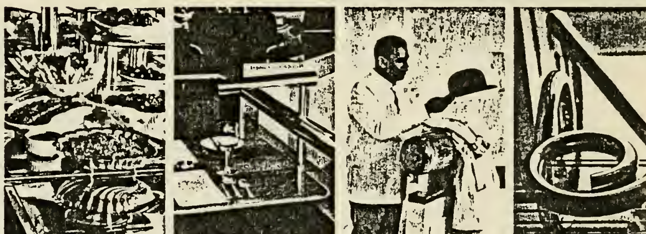
At right, the international cooks' table in The Grill (called, after three o'clock, The Hors d'Oeuvrerie). Various chefs preside in rotation. Here, Sadaharu Doira does the sushi, Gudny Paulsen the smørbrød.

People and patterns: *Pastry chef Albert Kumin, ass*

Smith, chef André René, Italian cookware, receptionist Beverly Rouse, chairs by Warren Platner in the West Parlor, $2.50 soap.

The War Room

On the 106th floor, just below the restaurant, Barbara Kafka, Joe Baum, Alan Lewis, and Kevin Zraly spent days on end plotting menus in what they came to call the war room. "Working with Joe," says Barbara Kafka "is fascinating, aggravating... and rewarding. He can drive you out of your skull. That Talmudic mind looks at everything from every side. He always expects more than you can do. And you do it."



Touches: *Dessert tables, place setting in Grill, coat checking, brass accent, captain Felicia Lee, liquor*

dow mock-up in his office and brooded. "For six months we argued, then finally I said, 'Sorry, Yama.'" Yamasaki visited The Club two weeks ago. "'You were right,' he told me. That made me feel good."

Two thousand names were suggested for the restaurant. "A marble contractor named Robert de Lazzero came up with the winner," Tozzoli remembers. "We were down in Puerto Rico. Caterina Valente was singing 'Windows of the World' . . . he turned it around a little."

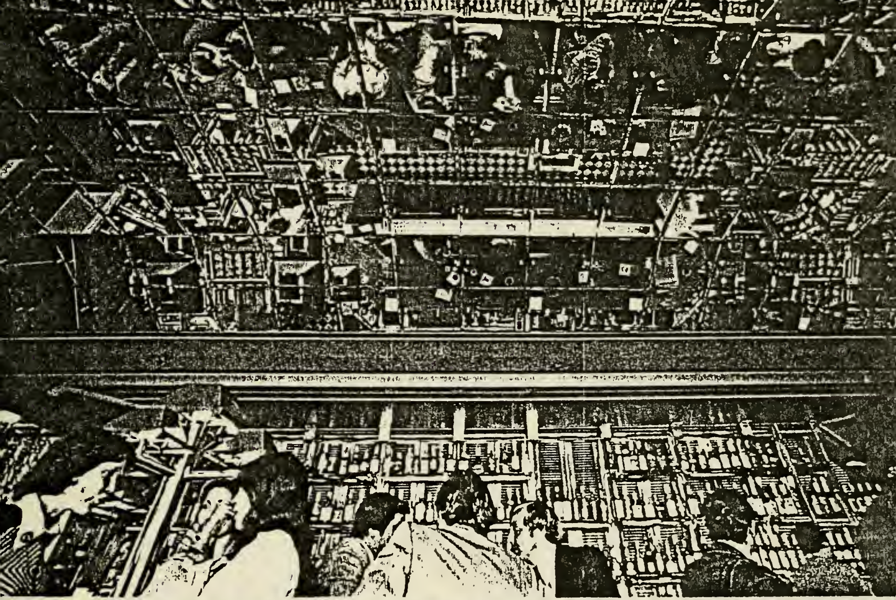
Joe Baum wanted to call it "For Spacious Skies." For a while he even signed letters "For Gracious Skies, Joe Baum."

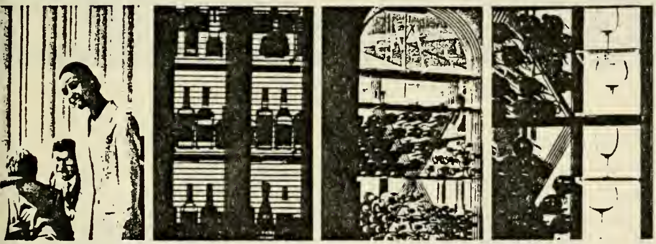
The member-recruitment brochure was irresistible—a seductive lyric of homemade potato chips, live trout, lead baffles for conference-room walls with no ears, never a soggy lettuce leaf, the concierge-miracle-maker. Not even the WTC's fiercest critic, Theodore Kheel, could resist. "Since my office is above Canal Street, the dues were only $100. What a buy," Kheel rejoices.

"On April 12th, 1976, the incredible Club at the World Trade Center will open its doors," the brochure declared. ("We'd scheduled it three times and postponed it. We just had to pick a date," Baum recalls.) *"It will be a private luncheon club the likes of which the city has never seen."*

The State Liquor Authority ruled it would not. The SLA demanded full public access at all times. A compromise was finally reached—120 nonmembers would be admitted at lunch for a $10 cover, plus $3 for each of their guests . . . The Restaurant would be open to all, no cover, from three on, and weekends. Baum is bitter. SLA chairman Mike Roth (offices in the WTC) paid a $13 entrance fee and got a window seat at lunch the first Friday in May.

The architect is the one in blue jeans—Warren Platner, calmly supervising a colleague with a staple gun on a ladder in Suite F. "We are putting doodads on





The Liquor Library

By day it's called "The Great Bar," by night "The City Lights Bar," and, in addition to mind-bending views of New York Bay, it boasts a "library" of 1,000 different labels of spirits—among them 130 kinds of Scotch, 76 kinds of gin. No matter where in the bar your table is, the mirrored ceiling lets you watch your drink being poured. And if you're in a hurry, the waiter will bring you something to eat at the counter.

els in the bar, and details of The Cellar in the Sky, a small restaurant that's also a working wine cave.

the wall," he says. "As architects we like to do the whole thing." Most of the artwork is still to come. "We held off ordering till we knew there'd be money left in the budget to pay for it." If there hadn't been? "We'd have done without." Platner looks like a country hick. Yet he has created a quietly sophisticated environment, so splendid the eye need not seek a window for joy.

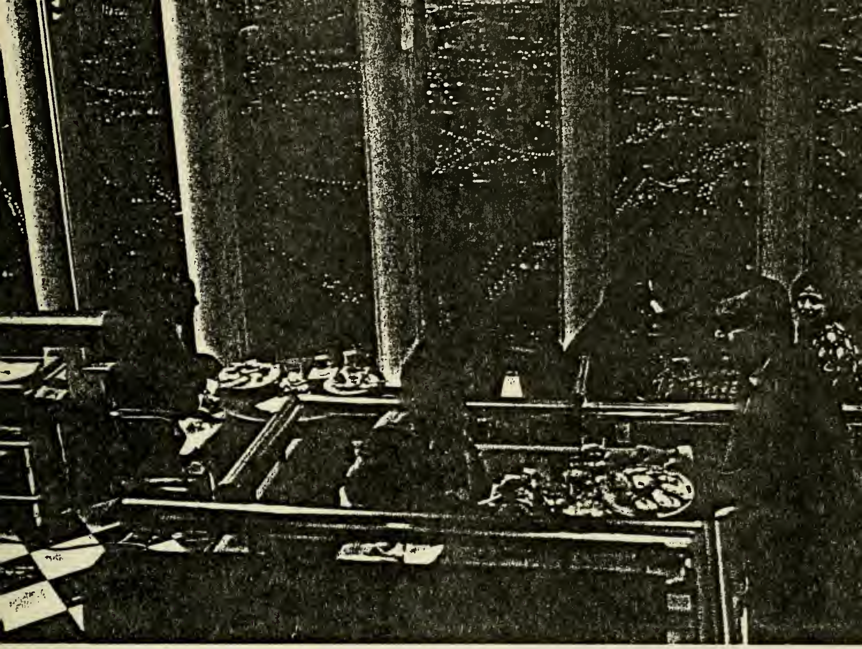
Without a trained eye or Platner as guide, you might not see the elaborate repetition of points in a square, the subtle distinction of velvet and wool and rattan and brass, the pattern of curve, the unlikely grayed-Easter-egg color in The Grill . . . nothing makes noise.

"There are no compromises here," Platner says, watching in fascination as two lingering drunks, holding each other up, navigate the mirrored glass of his Gallery, coming from the bar. "We had to trim our design and keep trimming to keep it within the inflationary spiral. That is the cheapest acoustical tile you can buy. We have acres of plasterboard. That way we can afford silk and gold leaf and brass and pink marble."

Cynics who long ago gave up quality forever will have to think again.

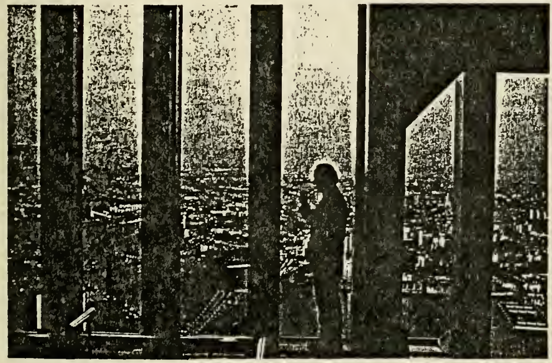
Joe Baum believes in consultants. James Beard has been Joe's giant muse for two decades. Jim fantasizes, spinning sense-numbing fancies by cassette: "There must be croissants that float in the air . . . fresh sorbets every half hour . . . fish hash I adore . . . blueberry slump and apple grunt and gooseberry fool . . . crab cakes luscious and hot and wonderful . . . last night I had a lamb ragout so wonderful you just wanted to cuddle it in your arms." And Joe wades through "all that excitement" asking, "What can I do? What's possible?"

All week the bodies have assembled in what will soon be Inhilco's 106th-floor offices—naked now except for Joe's desk and cookbooks on the floor, ringing the room. It's time to plan the dinner menu. Barbara Kafka, Baum's resident muse, calls up to The Club



The City Lights Bar: *Tables adjoining the bar command a view of Brooklyn, Queens, and, it seems on a clear night, the world.*

for Perrier. Club director Alan Lewis and his chef, André René, are here. And public-relations man Roger Martin. Lewis and Martin date back to R.A. days.



Joe Baum at rest: *Cynics who had given up on quality will have to think again.*

Barbara writes: "Country Pâté, Stuffed Baby Zucchini, Iced Cucumber Cream, Tomato Consommé With Thyme, Fresh Ham With Cream and Cider, Shimp Creole, Contrefilet With Mushroom Purée."

"This is $13.50. People are coming all the way downtown," says Joe. "Give me something you can use your teeth in."

"We have to have a fish dish," says Alan.

"Take out the fresh ham," says Joe.

"I like this item," says Barbara. "I want you to taste it."

"I've tasted it," says Joe. "Put an *r* in shrimp, dummy."

Barbara letters in: "Herb-Stuffed Bass in Lettuce."

"Beef," says Joe.

She writes:"Zrazy Nelson."

"What's that?"

"It's Russian. Beef sauté with cucumber and crisp fried onions on top," Barbara replies.

"I don't want to be accused of not giving them red meat at $13.50," says Joe. "We need a soup with guts," he says. Barbara is in her coat now, erasing. "I'm supposed to be home by seven-thirty to give my kids dinner," Joe sighs. Somehow he must be home by midnight to run the elevator in his strike-bound building.

"...What fine poetic justice if smørbrød and sashimi on top of what was jeered as a tombstone signal the city's rebirth..."

The third Friday after opening day. Breakfast in Joe's eighteenth-floor office. He tears off a piece of croissant. "Should be looser, flakier. We've got work to do."

"Angier Biddle Duke called to see if he could get William Randolph Hearst into the club." Taken care of.

"This is not our Danish dough," says Joe. "Don't give them to me as right unless they're right. Tell me what's wrong."

"It's my fault," confesses Al Ferraro, WTC director of food operations. "I just let it go. In my desire to get The Corner [a concourse coffee shop] open for breakfast, I let it go." Baum smashes his napkin across the desk. But it's only a napkin and it does not quite smash.

Joe studies a croissant. "A croissant is the same as shiny silver," he says. "They're good if they float away. Shiny silver is good if it's shiny."

There are two cracked glasses from The Club on his desk. "Something is wrong with the heat treatment on the edge. They've got to fix it or take them all back." Joe turns to his troubleshooter, Dennis Sweeney. "How many items on your punch list?" There are a few nervous giggles. Dennis swallows. "Two hundred." Joe is benevolent. "That's not too bad."

"I would like to get the damn beepers going," complains Lewis. Each waiter is to carry a beeper so the chef can signal when an order is ready.

"I sent them back to get the beeps lowered," says Joe.

"How about a silent beep? A pulsation?" someone asks. "How about a goose?"

"We tried that," says Joe. "A noiseless vibrator."

"But the waiters made too much noise," says Whiteman.

Jacques Pépin is hopping mad, hopping about the subterranean World Trade Center commissary with his bamboo walking stick—just recovering from a triple fracture. "I complained six months ago and it's still all wrong. If I tip that cauldron, I'll flood the kitchen."

Troubleshooter Sweeney is soothing. "I don't think this is impossible."

Under Baum's grand scheme, the commissary will supply 35 feeding stations throughout the WTC complex—from Coffee Express to Windows itself, everything dispatched by an omniscient computer. Pépin, creator of the successful Potagerie concept, former chef of the Elysée palace, very spiffy in white laboratory coat and blue jeans, is organizing the commissary. At the moment it is mostly vast space, fresh cement, and Albert Kumin's bakery.

"The commissary will do soups and sauces—velouté, nantua, duglère, all the stocks. We'll have plastic sacks of cooked chicken off the bone. Each restaurant orders what it needs," Pépin explains. He tastes a nantua sauce. "Too salty," he says. "Our beef burgundy will be chunks of meat and sauce. A luncheonette will serve it on noodles adding carrots. Crisp, I hope. Upstairs in The Club, they would double the meat and serve it with glazed onions, mushrooms, and tiny lardons of pork."

Pépin is preparing a book of procedures—each "store" will have detailed instructions for how to use the product without ruining it. "I know I can control the commissary. But it's up to the restaurant to control the kitchens.

"These corn fritters." He makes a face. "They're terrible. They ruin them. I tasted one and it was lousy. Not fried in the middle. I said, do it on the griddle. So now maybe they will cook 30 ahead . . . that ruins them too."

The man who will run the commissary, Michel Bonnettat, an old teammate from Pépin's days at Pavillon, brings in a corn fritter. And then another. "It's still not right," says Jacques. Bonnettat returns with two plump, crisp little fritters.

"You cooked these in fresh fat," says Pépin. "Very good. Now if I could only get them to boil an egg right." But mostly Pépin is pleased with The Corner's kitchen recruits from the CIA. "It's better to train a guy who's never done it. They're good because they don't know everything. If you get a professional, he's been a broiler guy for twenty years; he only knows *his* way to do it—simmer the sole in water, press the hamburger till all the juices run out." He sighs.

Dennis Sweeney is on the phone. The wheels have fallen off the oven salamander.

Ted Kheel is eating sushi and sipping a fine dry Chablis in memory of the Courtesy Sandwich Shop. Courtesy "et al." fought the giant Port Authoriy in court . . . and lost, provoking a minority opinion that matches Kheel's own: the Authority's sprawl into real estate is socialism. "It's socialism at its worst," says Kheel. "I drove the *Daily News* crazy with that sentence." I wouldn't want to suggest that our town's most brilliant arbiter and influential spokesman for mass transit is naïve. But Ted Kheel persists in believing that the Port Authority should do something about mass transportation simply because that is its mandate.

"Has anyone ordered his own private cellar yet?" Kheel asks Kevin Zraly, the cellarmaster Joe recruited from the De Puy Canal House Tavern in High Falls, New York.

"Not yet," says Kevin. "I just finished our wine list this morning. That's why I'm smiling."

"Good," says Kheel. "Then I'll have cellar number one. This place is fabulous. This is New York. I said they should tear down the building. Now I say, tear it down but leave the 107th floor. I sit here. This is bittersweet. This is irony in the extreme. Joe has done for food delivery what the Port Authority was supposed to do for people delivery. Guy Tozzoli has great talent. Put him to work on mass transit. The elevator gets up here in 58 seconds. That's the fastest form of vertical transportation in the world, but the P.A. was formed to do something about horizontal transportation. The ghost of Austin Tobin stalks these halls saying 'Thou shalt not do a goddamned thing for mass transportation because there's not any money in it.' "

He studies Kevin's wine-purchase proposal. "I want to add two cases of this Cabernet," he says, "and two of Freemark Abbey Pinot Chardonnay. As long as they don't tear this place down pursuant to my suggestion, I'm going to enjoy it."

It is night. There is a meek sliver of moon. From the Promenade, the East River is a dotty *grande dame* wearing all her diamonds at once. This is where I want to dance. O beautiful for spacious subterranean parking! I will brave the muggers yet to come, the wilderness menace of the downtown nighttime desert. What fine poetic justice if smørbrød and sashimi and strawberry shortcake on top of what once was jeered as a steel-faced tombstone signal the city's rebirth.

Of course, could be Joe Baum is just another sorcerer. Could be a trance I'm in . . . a brilliant illusion. I will step off this exhilarating high, swoop 1,350 feet in 58 seconds to the ground below. The doors will open. And things will be the same. ■

The Limited-Dividend Approach to For-Profit Housing

Melvin Epstein

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Section II

Considerations in Packaging a Product

INTRODUCTION

When community groups act as developers of a specific type of housing -- namely, a limited-dividend (for-profit) enterprise under the FHA Section 236 program—not only the mortgage support of FHA but also a variety of potential arrangements in the community's relationship with a builder and with investors are involved.[1] A step by step analysis of the packaging procedure should be useful.

This section begins by describing FHA mortgage processing, then explores the different types of financial relationships that the community group might choose. Examining a real case still in the process of being packaged, the section presents specific financial figures to illustrate how the pieces have to fit together. (The author is serving as a consultant to the community group concerned.) This community group is the sole developer and contracts with a builder, but other kinds of relationships with a builder can also be chosen that would change the finance and development problems to be faced. These other choices are presented so that a community group can see what considerations are involved with regard to profitability, control, and attractiveness to investors.

Finally, the section presents a number of considerations that a group must look at when making a deal with outside investors. All of these will also affect the profitability and degree of control held by the community group.

FHA/HUD PROCESSING PROCEDURES

The developer hopes to develop a multiple unit project under Section 236 of the Federal Housing Law. He must locate a specific piece of land which is suitable for the kind of development he would

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1. This paper assumes an understanding of the basic elements of the limited-dividend form of sponsorship described in Housing Development: A Tool for Community Economic Development in Low-Income Areas, by James Morey and Melvin Epstein (Cambridge, Mass., Center for Community Economic Development, 1971).

like to see in the community and proceed to hire an architect and builder to determine in a preliminary way whether a project on that site is feasible. The aim of this initial effort is to collect enough basic information to have a prefeasibility conference with the local FHA office. Architectural drawings are not necessary at this time.

At the prefeasibility conference the potential developer describes the general nature of the proposed project. HUD expects the developer to demonstrate the need for the proposed housing. This is done by comparing the rough estimate of rent levels and operating costs in the proposed project to current rent levels and vacancy rates in the area. The developer presents his view of the project's rentability and the attitude of the community toward such a project. He will probably be called upon to indicate the proposed number of units with estimates of construction costs, taxes and operating expenses, and total replacement cost. The function of this conference is to let the HUD office know of his plans so that HUD has the opportunity to offer its view of the project's feasibility at an early stage. This conference assumes that the developer has control of a site, either through option or ownership.

Assuming that HUD gives a favorable judgment on the potential of such a project, the developer then begins work on the next stages, which include a management plan for the project and an application for a letter of feasibility. HUD has put increased emphasis on the management of low-income housing, since this has proved to be a serious problem in many inner-city areas. A good management plan is a crucial element for obtaining FHA approval; however, I will not go into the details of a management plan in this section. [2]

The key part of the application for a letter of feasibility is submitting an FHA 2013 Form, Application for Project Mortgage Insurance, which is included in this section. The FHA 2013 Form con-

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2. HUD has developed a management guide book which should be referred to. For details on a management plan, see Management of HUD Insured Multi-Family Projects under Section 221(d)(3) and Section 236, a HUD guide, HM G4351, July 1971.

tains the basic financial elements that must be considered in planning a project. The information supplied on the 2013 Form will determine whether the proposed rent levels can support the mortgage payments, the operating expenses, and the 6 percent cash distribution on the "implied equity."[3] The size of the mortgage is limited by the rents that can be charged.[4] The amount of rent that can be charged is restricted by FHA tenant income limits, which are 135 percent of the income limits established for public housing.[5] For instance, in Boston, Massachusetts, the 236 income limit for a family of four is $7,695 as of February 1970. The maximum basic rent for initial occupancy is 25 percent of the income limit or $160 per month in Boston for a family of four. Families whose income is lower than the income limit can be admitted but they will be paying more than 25 percent of their income for rent.

From one to six months after submittal of the 2013 Form and related documents such as Evidence of Site Control, Location Map, Personal Financial and Credit Statement of Sponsor, and Equal Employment Opportunity Certification, the HUD Area Office will call the proposed sponsor in for a feasibility conference. No architectural drawings are required at this point nor are there any HUD fees. At this conference, there is a more detailed discussion of market and economic feasibility, project location, site layout and design, and management plan. If all these factors are satisfactory, HUD will issue

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3. "Implied equity" equals 10 percent of total replacement cost. The mortgage equals 90 percent of total replacement cost. The term "implied equity" derives from the fact that the actual amount contributed by investors can be more or less than 10 percent of total replacement cost, but the 6 percent dividend is based on the implied equity. See p. 34.

4. See HUD Circular HPMA-FHA, 4442.3A, July 29, 1971, Section 236 -- Developing Feasible Projects.

5. If the regular income limits are not enough to make the project feasible, exception income limits (90 percent of Section 221(b)(3) limits) can sometimes be used. HUD area offices are reluctant to use exception limits but they do have the authority to apply them for part or all of a project. See HUD Circular FHA 4442.4, July 22, 1969.

a Feasibility Letter inviting the potential sponsor to submit an application for firm (conditional) commitment in accordance with basic project characteristics which are specified.[6] These include number and composition of units, estimated project income, maximum replacement cost, FHA land value, carrying and financing charges, construction budget (which includes builder's overhead and builder's and sponsor's profit and risk allowance), architect fees, and legal and organizational fees. The letter also specifies the maximum insurable mortgage, the estimated cash requirements at the close of the mortgage, and the amount of interest subsidy which has been reserved. The Feasibility Letter sets a time limit (60 to 90 days) for submittal of an application for firm (conditional) commitment.

The potential sponsor now instructs his architect to draw final plans. He also negotiates a firm price with his builder. He then applies for firm commitment by submitting a revised 2013 Form and related documents. These documents include Architect's Plans and Specifications, Land Survey and Surveyor's Certificate, and Architect's Errors and Omissions Insurance. The revised 2013 Form is based on firm prices instead of previous estimates. HUD charges a nonrefundable application fee which is $3 for each thousand dollars of the mortgage amount. This fee is covered by the mortgage when and if it is issued. If everything meets the proper specifications, HUD issues a firm commitment for mortgage insurance and the interest

6. If the potential sponsor is inexperienced, HUD will ask him to apply for conditional commitment before applying for firm commitment. Conditional commitment is an additional stage which provides for further communication between the sponsor and the HUD area office before architectural drawings and negotiations with the contractor are finalized. Included among the tasks to be performed during conditional commitment are the preparation of preliminary architectural drawings, selection of and preliminary negotiations with a contractor, and revision of previously filed forms based on the new information.

subsidy. There are now a whole series of legal documents which must be prepared for initial close, at which point construction can begin. With firm commitment, the developer has completed the bulk of the development work prior to the start of construction. He has met HUD requirements, and HUD has legally bound itself to supply mortgage insurance and interest subsidy within specified limits. Without the FHA or some similar form of government subsidy, a feasible project in a poor community is almost impossible to bring to fruition.

Thus far I have described only FHA/HUD mortgage processing. In order to secure a firm commitment, there are a multitude of tasks to be performed which have not been discussed in any detail; these tasks require experience to perform well. For instance, assembling land at a cost that will permit low-income housing can be a major undertaking. It requires knowledge of federal programs such as urban renewal, which buys land and provides it at a minimum price to developers. If land acquisition is done privately, it requires a knowledge of techniques which will not unreasonably inflate the purchase price in assembling the numerous parcels which are usually required for a project. One must have the ability to make judgments, to negotiate, and to employ various technical skills. The developer coordinates the numerous elements. The success or failure of the project rests with him.

It is important to note that money must be spent even before there is any assurance that there will be a project. Options on land cost money, government agencies require fees for processing applications, architects must be paid for their plans, and housing consultants paid for feasibility studies. This initial outlay can account for 3 to 10 percent of the project.

A SAMPLE PROJECT

Table II. 1 presents a summary of project costs under a Section 236 limited-dividend project recently filed in an inner-city area. The plan calls for 160 units, 116 in a high rise structure and 44 town house units. The high rise structure contains 78 one-bedroom and 38 two-bedroom units. The town house units contain 12 two-bedroom, 20 three-bedroom, and 12 four-bedroom units. Table II. 1 abstracts the most significant line items from the 2013 Form.

Table II. 1 - Summary of Project Costs as Abstracted from FHA Form 2013

Line/Item no.	Description of projected costs	Dollars
36C	Total land improvements	$ 84, 500
41	Total structure cost	2, 147, 100
42	General requirements	49, 100
44	Builder's profit (waived)	--------
49	Fees (includes builder's overhead of $45, 600)	156, 200
50	Total improvements (sum: 36C, 41, 42, 49)	2, 436, 900
63	Carrying and financing	394, 892
66	Legal and organizational	5, 000
68	Builder's and sponsor's profit and risk allowance	283, 679
69	Total development cost (sum: 50, 63, 66, 68)	3, 120, 471
70	Land	160, 000
71	Total replacement cost	3, 280, 471
	FHA mortgage (90 percent of line 71)	$2, 952, 423

Builder's Overhead and Profit

According to the data in Table II. 2, the builder has told the developer that his total costs for construction of the 160 units will be \$2,280,700. This is the sum of line items 36C, "total land improvements"; 41, "total structure costs"; and 42, "general requirements."[7]

Table II. 2 - Builder's Profit as Abstracted from FHA Form 2013

Line item no.	Description of projected costs	Dollars
36C	Total land improvements	\$ 84,500
41	Total structure cost	2,147,100
42	General requirements	49,100
	Total costs related to construction	2,280,700
	Builder's overhead 2 percent	45,600
	Builder share of syndication profits	113,000

Together these three items represent the physical improvements in the project exclusive of fees, carrying charges, and builder's overhead and profit. It is on the basis of these items that the builder negotiates his profit. The builder has been given a 2 percent overhead allowance, which is included as line item 43 and comes out of the mortgage proceeds. In this case, the overhead is \$45,600. In addition to this overhead allowance, the builder has asked for a profit which is not included in the mortgage proceeds under the limited-dividend form of sponsorship. Therefore, the profit must be paid

7. "General requirements" refer to ancillary costs during construction, such as fencing around the project and a temporary trailer.

from the syndication proceeds of the developer. [8] The builder has asked for $113,000 fee, which is about 5 percent of the total physical improvement cost. If an Identity of Interest [9] is declared by the builder and sponsor, HUD allows what is known as a Builder's and Sponsor's [10] Profit and Risk Allowance (BSPRA). The BSPRA equals 10 percent of all project costs exclusive of land and BSPRA, which in this case is equivalent to $283,679.

Cash Requirement and BSPRA

Table II. 3 and Figure II. 1 show that in order to complete the project, the sponsor must contribute some cash, exclusive of any profit that he and the builder may obtain. Table II. 3 and Figure II. 1 present two methods of arriving at the amount of cash which is required from the developer. One key to understanding these methods is a firm grasp of the concept of BSPRA. The Builder's and Sponsor's Profit and Risk Allow-

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8. Syndication is the sale of an ownership interest in the project by the developer to high tax bracket individuals who receive a 6 percent cash dividend plus the right to use the losses of the project on their personal income tax return, thus reducing the amount of tax they have to pay. See pages 33 and 35 for further discussion.

9. Identity of Interest is never explicitly defined in HUD regulations, but it means that some form of business relationship exists between the mortgagor (developer and sponsor) and general contractor (builder). In FHA Form 2330, Mortgagor's Certificate of Actual Cost, some examples are given. These show that an Identity of Interest exists when a contractor (builder) takes stock or any interest in the mortgagor as part of the consideration paid to him, when there is any financial interest of the mortgagor in the contractor, or when one or more of the officers, directors, or stockholders of the mortgagor is also an officer, director, or stockholder of the contractor.

10. "Sponsor" is equivalent to "developer" as used in this paper.

ance (BSPRA), included as line item 68 on the 2013 form, can be pledged by the developer against cash requirements. It is not a cash item in the sense that all the other elements of total replacement cost are. The structure cost, the fees, and the carrying and financing cost must be paid if the building is to be built. The developer, however, does not have to pay the BSPRA because he would paying it to himself. This is why he can pledge it against cash requirements to reduce the amount of cash he must invest in the project.

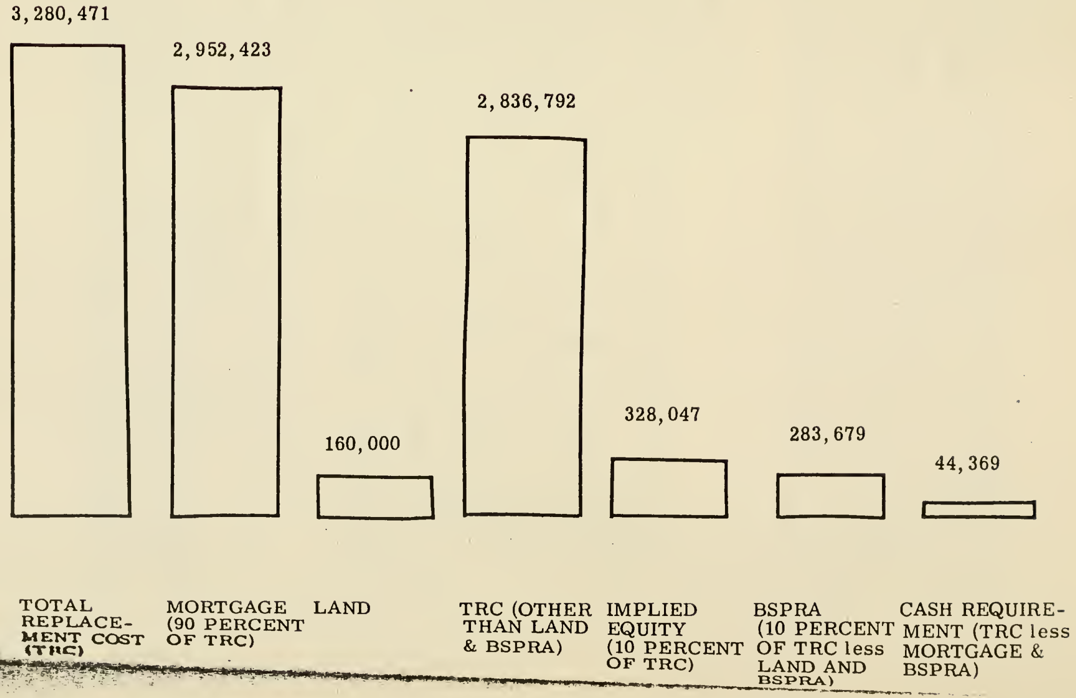
Table II. 3 - Cash Requirements as Abstracted from FHA Form 2013

Line item no.	Description of projected costs	Dollars
50	Total improvements	$2,436,900
63	Carrying and financing	394,892
66	Legal and organizational	5,000
70	Land	160,000
	Total cash costs to complete project	2,996,792
	Less FHA mortgage	2,952,423
83	Cash required from developer	44,369

The BSPRA is calculated by taking 10 percent of all project costs exclusive of land. Since BSPRA itself is included in total project cost, one must also exclude BSPRA when multiplying by 10 percent.

Figure II. 1 indicates that the cash requirement is $44,369. This was calculated by taking total replacement cost less the cash to be contributed by the mortgage less the BSPRA, the item in total replacement cost which is pledged against cash requirements.

Figure II. 1 - Constituent Cost Elements of an FHA 236 Limited-Dividend Project



In Table II. 3, the same figure is arrived at by adding all the cash items (BSPRA is not treated as a cash item) in total replacement cost and subtracting the amount of the mortgage to obtain the cash required from the developer or $44,369. I have assumed that the 2 percent working capital requirement (2 percent of the mortgage) is supplied by a letter of credit. I have also excluded from current consideration the 15 percent net worth requirement (15 percent of capital contribution to the limited partnership) which is a rule of the Internal Revenue Service.

Tax Shelter Syndication

The developer must obtain the money necessary for the cash requirement, the builder's profit, and his own profit. These funds are obtained by forming a limited partnership and selling the tax shelter, a process known as syndication. The limited partnership usually includes the developer as general partner with limited partners who have made an investment in the partnership in return for an annual 6 percent cash dividend on the implied equity [11] and tax benefits obtainable from the accelerated depreciation allowed for housing. [12] The net syndication value of a new apartment development varies from 8 to 15 percent of the mortgage. [13] In this case, I have assumed a syndication value of 11.7 percent of the mortgage. I have further

11. Implied equity is equivalent to 10 percent of the Total Replacement Cost or $328,047 in this case.

12. For a detailed description of the syndication process, see Morcy and Epstein, Housing Development, pp. 21-41.

13. A low-income rehabilitation project can usually be syndicated for about 20 percent of the mortgage because of quicker depreciation allowed for such projects. Rehabilitation is considered to be a more risky investment than new construction. There tends to be a great variation in the percentage of the mortgage which will be invested. Many investors will offer no more than 10 percent to 12 percent of the mortgage.

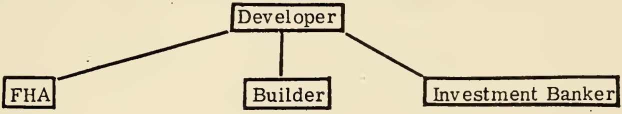
assumed that 99 percent has been sold to the limited partners with the general partner retaining 1 percent. Thus, 11.7 percent of the 99 percent of the mortgage is equivalent to $341,979. The developer must use this money to satisfy the cash requirements of the project as well as pay the builder his profit. After making these disbursements, the developer has a total profit of $184,610 (see Table II.4), which is 6.2 percent of the mortgage.

Table II.4 - Profitability Analysis
(assuming 11.7 percent syndication and sole developer-general partner)

Net syndication		$341,979
Disbursements		
Cash requirements of project	$ 44,369	
Profit to builder	$113,000	
		157,369
Total profit to developer		$184,610

The overall profitability and success of a project is dependent on the developer's ability to make satisfactory arrangements with three major parties: (1) the FHA, for mortgage insurance and interest subsidy; (2) the builder, for the amount he requires to construct the project and the share of syndication proceeds he wants as his profit, and (3) the investment banker, for the amount of money he is prepared to raise from limited partners as syndication proceeds to the developer. (See Figure II.2).

Figure II. 2 - CDC as Sole Developer



At the beginning of this paper, I described the FHA processing procedures and the elements which must be coordinated in order to obtain a firm commitment from the FHA. One element in this process that can have a significant effect on overall profitability is the amount the FHA allows for construction. The more the builder is allowed for construction, the more amenable he will be to accepting less from syndication proceeds as his profit. Under the limited-dividend form of sponsorship, the amount the builder receives as his profit is entirely negotiable. In our example, the builder receives 5 percent of structure cost from the proceeds of the syndication in addition to a 2 percent overhead allowance from the proceeds of the mortgage. Some builders will accept a fee of 3 percent of structure cost from syndication proceeds if they feel that there is enough money allocated to structure cost in the mortgage. In the example discussed above, the developer would have increased his profit by about $40,000 had the builder accepted 3 percent of structure cost as profit instead of 5 percent.

Changing the Structure of the Relationships

There are a number of ways to alter the profit picture by changing the structure of relationships between the developer, builder, and banker. I have used the term developer to mean the group that coordinates and takes ultimate responsibility for all the elements of a project. A community development corporation can play this role

alone or it can have a co-developer to help it. Usually this co-developer is the builder. Such an arrangement is presented in Figure II. 3.

Figure II. 3 - CDC as Co-Developer

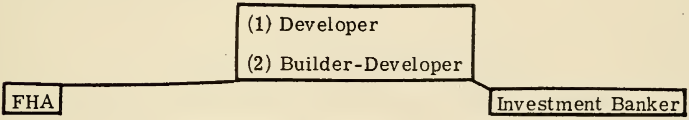
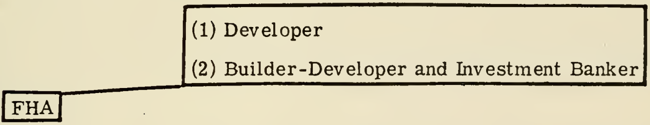


Figure II.4 illustrates a situation in which the builder-developer also functions as the investment banker. This means that in addition to performing the developer's and builder's roles, he also raises money from investors. The structural changes outlined in Figures II. 3 and II. 4 will have an effect on the developer's profit and on his rights and responsibilities in the limited partnership. The exact effect of these changes will be different in each situation, depending on the stature of the parties involved, their resources, their negotiating skill, and the syndication market at the time.

Figure II. 4 - CDC as Co-Developer and Investment Banker



Effect of Different Arrangements. In Table II. 5 I have assumed that the sole developer (of Table II. 4) has reconsidered and formed a joint venture with a builder-developer as in Figure II. 3. The agreement they have reached is to share the profits equally. The CDC has done all the work and spent the front

money to obtain a firm commitment from the FHA. This means that the CDC has obtained the land, hired an architect, and generally cleared the way in the local community for the project. The builder will build the project and act as advisor and as co-general partner in the limited partnership.

Table II. 5 - Profitability Analysis
(assuming 13.8 percent syndication and builder-developer)

Net syndication (13.8% of 99% of $2,952,423)		$403,360
Cash requirements of project		44,369
Total profit to co-developers		$358,991
Profit to builder-developer (50%)	$179,495	
Profit to CDC-developer (50%)	$179,495	

The result is that the profit to the CDC is equivalent to the profit in the case in which it was sole general partner ($179,495 vs. $184,610). It is assumed that the stature of the builder-developer would result in greater net syndication proceeds (13.8 percent instead of 11.7 percent) and that the builder-developer would be willing to build for the 2 percent overhead from the mortgage plus his share of profits. This arrangement increases the builder's profit from $113,000 (see Table II. 2) to $179,495.

There is another advantage to a joint venture with an experienced, well-financed builder-developer. The Internal Revenue Service requires that a sole corporate general partner have a net worth of 15 percent of the capital contribution to the partnership. The interest in the limited partnership is excluded in this determination. This means that the CDC as sole general partner in this case would have to have

approximately $50,000 from other sources, [14] $15,000 for every $100,000 invested by the limited partners. A builder-developer could offer the net worth to meet this requirement.

There is also a requirement for working capital equal to 2 percent of the mortgage. In the case under discussion, this would mean that the CDC would have to come up with $59,000 at initial close. I have assumed that this requirement will be met by a letter of credit from a bank. A builder-developer would probably find it easier to obtain this letter of credit than would a CDC.

Thus far I have been speaking of net syndication proceeds. There are also gross proceeds, the amount the limited partners actually invest. This gross amount is usually reduced by 15 percent to arrive at net proceeds. The 15 percent is the cost of syndication; it includes lawyers' and accountants' fees for preparation of the private placement memo and limited-partnership agreement, and brokers' and investment bankers' fees. Sometimes a builder-developer is able to syndicate (as in Figure II.4) through his own channels at a cost of 10 percent instead of 15 percent. Table II. 6 indicates that with an identical mortgage, syndication at a cost of 10 percent of the amount invested instead of 15 percent results in additional proceeds to the general partners of $22,000.

Table II. 6 - Comparison of Profits Possible at Syndication Costs of 10 and 15 Percent (assuming mortgage of $2,952,423)

Gross syndication (15. 15% of 99% of mortgage)		$442,863		$442,863
Syndication costs (at 10% and 15%)	at 10%	44,286	at 15%	66,429
Net before disbursements		398,577		376,434
Cash-requirements of project		44,369		44,369
Total proceeds to General Partners		$354,208		$332,065

14. See Rev. Proc. 72-13, Internal Revenue Bulletin (1972-73), p. 26.

Another variation of the Figure II. 4 structure would be a situation in which a CDC has gained rights to land suitable for development through the local urban renewal process. This CDC does not have the funds or the expertise to act as developer. In return for contributing the land to a partnership and acting as co-general partner, the builder-developer might offer the CDC a fee of $100,000 payable at final close for a project with a mortgage of $3 million. The builder-developer would do all the development work and keep whatever profits it earned.

OTHER IMPORTANT CONSIDERATIONS

Thus far we have been concerned with the total amount of syndication proceeds and how these are distributed between the builder and developer. There are a number of other important issues in the syndication of a housing partnership which will be considered below. These are the phasing of syndication proceeds, management rights, coverage of cost overruns during construction and operating losses after construction, ownership of residual value, and other guarantees, escrows, or subordinations which might be requested.

Phasing

Investment bankers prefer to make their investment in a project as a series of payments rather than paying the whole amount at initial close. One standard payment procedure would be 1/3 of the syndication proceeds at initial close, 1/3 at 50 percent construction completion, and the remaining 1/3 at final close. A less favorable payment schedule from the point of view of the developer would be 1/3 at initial close, 1/3 at final close, and 1/3 one year after final close. An even less favorable schedule would tie the final payment to certain conditions being met, such as the project reaching a break-even level in terms of operating

costs. This condition increases the security of the investment for the passive investor. The payment terms are an item of negotiation between the developer and the investment banker. [15]

Phasing payments increases the rate of return to investors for a given investment. By agreeing to receive phased payments, a developer enables an investment banker to raise more money and offer the same return to investors than if all the payments were due at the start of construction. [16] On the other hand, a developer must consider his cash needs before agreeing to a phased payment schedule. He must determine whether the initial payment will cover the cash requirements of the project. [17] The increase in funds obtained from phasing usually justifies a loan for a year to cover cash needs until the final payments are received. [18]

Cost Overruns During Construction

A major risk from an investor's point of view is that the project will not be completed for the amount provided by the mortgage. Most investment bankers will request that construction cost overruns be covered by the local general partner, as is done in Section 2 of the standard National Housing Partnership Agreement. If a project runs into trouble, cost overruns can be significant, and most CDCs do not

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15. See Article 5.2 (b) of the Limited Partnership Agreement.

16. In one case, phasing of payments at initial close, final close, and one year after final close would have enabled a CDC to raise 1/3 more money and to offer the same return that would have been offered if money had been paid at initial close. See Morey and Epstein, Housing Development, p. 39.

17. In the example discussed in Table. II. 1, 1/3 of the syndication value or $113,000 would come in at initial close. This would cover the $44,000 cash requirement as well as the $60,000 working capital requirement.

18. See Morey and Epstein, Housing Development, p. 40.

have the resources to cover a major overrun. This is one reason why many bankers will not accept a CDC as sole general partner.

One way of protecting against overruns is to require the builder to obtain a 100 percent bond. Even such a bond is not full protection. If a builder fails after 50 percent of the work had been completed, the bonding company will provide the remaining 50 percent. However, it usually requires more than the remaining 50 percent to bring in a new builder to complete the job. Also, a bond does not cover carrying costs above the budgeted amount which might be caused by delays in construction due to a strike.

One way for a CDC to handle cost overruns is to get a large builder to agree to a fixed-price contract which means that if it costs more to do the specified work than the builder expected, he will do the work at his own expense. The builder would not be responsible for changes from the original plan. In return, the builder would ask for a greater profit. The fixed-price contract and bonding requirements tend to make it harder for a CDC to use a minority-owned building firm. These firms generally have difficulty obtaining a bond and do not have adequate resources to cover overruns.

Management

Once the housing is completed, most CDCs would prefer to manage the property or designate a local management group to manage it for them. While most investment bankers will agree to such an arrangement, they usually make it conditional. For instance, the National Housing Partnership (NHP) reserves the right to remove the local general partner as manager of the project at any time it chooses. There is no limit on this right. In practice, the NHP has no incentive to do this unless the project is losing money. Nevertheless, many CDCs would prefer to place a limit on the right of the limited partners or co-general partner to remove them from management. One way of doing this is to specify the level of operating losses as the trigger for removal. A CDC might place a portion of its syndication proceeds in

escrow to cover these losses.

Another arrangement is to have a well-known management agent take responsibility for the management with the intent of subcontracting the job to a local management group acceptable to the CDC. Some investment bankers are willing to go along with this arrangement, because they feel that the well-known management company is putting its reputation on the line.

Subordination of Management Fee

In order to increase the likelihood that an investor will receive the 6 percent dividend, some investment bankers ask that the management fee be subordinated to the dividend payment. This means that in a given year if there is not enough money from operations to pay both the management fee and the dividend, only the dividend will be paid. Some bankers will allow 40 percent of the management fee to be paid with the remainder to go toward the 6 percent dividend.

Operating Deficits

The second major risk to an investor is that, once completed, the project will run deficits so large that it will eventually fall into foreclosure. Investment bankers might ask the CDC to establish an escrow fund to cover any deficits. If it becomes necessary to use such funds, the CDC can agree to use them out of escrow in the form of a loan to be repaid out of any future surplus, or alternatively the funds could be used in such a manner that the CDC will have no further rights to them.

A co-general partner might agree to support operating deficits in the form of a loan if the CDC has also placed in escrow part of its proceeds to cover such deficits. As is the case with construction cost overruns, the potential for operating deficits makes investment bankers reluctant to invest in a project that does not include a financially strong partner.

A unique feature of the deal that the National Housing Partnership offers developers is that NHP will cover operating deficits to the extent of its ownership interest in the project. This interest can be as much as 95 to 99 percent. Such a commitment on the part of NHP virtually assures the life of the project. This is a very strong part of the NHP offer in view of the fact that some investment bankers are reluctant to invest in inner-city projects.

Residual Value

Part of the negotiation process is to determine who will own the project when the limited partners want to sell at some date in the future when they receive the bulk of the tax benefits. Many investment bankers do not consider residual ownership an important factor. Others, such as the National Housing Partnership, prefer to have the same proportion of residual ownership that they had upon initial investment. Still others tend to prefer a 50/50 split of the residual value.

Although the National Housing Partnership prefers to maintain full ownership, it does provide a clause which allows a cooperative formed by the tenants to buy the project for the outstanding mortgage plus the original capital contribution of the limited partners. The tenants can take this option at any time after the initial close.

The ability of a tenant group to buy a project is dependent upon its ability to arrange financing. Financing is available under Section 236(j) of the Housing and Urban Development Act of 1968, which authorizes HUD to insure a mortgage loan for 100 percent of the purchase price in a transfer from a private owner to a nonprofit corporation or a tenant cooperative. The new mortgage can get as much as 100 percent of original, HUD approved, project replacement cost if the appraisal justifies such a price. In such a sale an investor can usually recover his original investment after paying taxes on the sale.

The change in proportion of ownership by the general partner and the limited partners from the usual 5 to 95 percent split can be specified

in the partnership agreement in two ways, through a flip-flop or a sale. A flip-flop means that at some specified point the interest of the limited partners will be reduced from 95 percent to some lesser amount, while the interest of the general partner is increased from 5 percent to an amount greater than that held by the limited partners. The changeover can be made when the limited partners have recouped their cash investment or 20 years after final endorsement, whichever is sooner. Some lawyers feel that the changeover should never be more than 50-50, while others allow a 70-30 or greater changeover in favor of the community group (general partner). The consideration here is that from the point of view of the Internal Revenue Service it must look like the investors are making a legitimate investment which means economic benefits from the project other than the tax benefits. The more extreme the degree of flip-flop, that is, the less the limited partners end up owning, the more likely it will be that the IRS will take the view that there was no legitimate investment and that the investors are not entitled to the tax benefits. One should act on the advice of a tax lawyer before making any flip-flop arrangement.

There is some question as to whether a sale can be specified in the partnership agreement without jeopardizing the ability of investors to utilize the tax shelter. Conservative tax counsel would tend to advise that no specification of a sale should be put in the partnership agreement. They would argue that such a provision would mean that limited partners never really owned the project and, therefore, are not entitled to the tax benefits. Less conservative counsel would say that whether a specification of sale nullifies the tax benefits is dependent on the nature of the specification. For instance, less conservative counsel might say that an option 20 years from now could be inserted into the agreement, if it is at a "reasonable" price. Many CDCs place a high value on the ability to own a project after 20 years. Tax advice must be sought, however, before formalizing the sale in the partnership agreement.

National Housing Partnerships

The NHP is chartered under a 1968 Housing Act to invest in limited-dividend housing projects. It has become a major force in the investment banking market for low- and moderate-income projects. The NHP has three basic arrangements (known as Mark 1, 2, and 3) that it will make with local developers.

Under its Mark 1 arrangement, the NHP will take anywhere from a 25 to 99 percent interest in a project. Usually 1 percent of this interest is in a general partnership position with the remainder as a limited partner. NHP tends to value projects at between 9 and 11 percent of the mortgage. While this is somewhat less than other investment bankers offer, NHP tends to invest in inner-city areas and covers operating deficits to the extent of its ownership interest. Other bankers are reluctant to invest in inner-city areas, and most will not cover operating deficits. A basic part of NHP's arrangement, however, is the right to take over management whenever it decides it is necessary.

A community group, with whom the author has consulted was recently offered 11.25 percent of the mortgage by NHP under its Mark 1 arrangement. NHP wanted a guarantee that construction would be completed. No one connected with the project was willing to give such a guarantee. Short of a guarantee NHP wanted to postpone syndication payments to the community group until construction was completed. NHP would pay out of syndication proceeds the cash requirements at initial close and 17 percent of the syndication proceeds to the builder at 50 percent completion. The remainder would be paid to the community group at final close.

There is a competing offer from a private banker for 13.8 percent of the mortgage. The banker would pay 30 percent of the proceeds at initial close, 40 percent when construction is 50 percent complete, and 30 percent when the building reaches 90 percent occupancy. Both offers are still under consideration.

The NHP Mark 2 arrangement is the same as the Mark 1 except that NHP also offers to make a seed money loan. This seed money loan

is at 2 percent above prime and is repayable at initial close. It is offered for use between the time a group obtains a feasibility letter and initial close. It can be used for optioning or purchasing land, architectural drawings, and test borings. NHP might discount the syndication valuation about 1 percent to take account of the fact that it has offered a seed money loan.

The Mark 3 arrangement is one in which NHP will act as general partner and developer of a project. It is suitable for those nonprofit groups that have neither the money nor the expertise to do housing development. In return for handling relationships with the local community, NHP might offer the local group a fee of 1 percent of mortgage or 1/2 of the 6 percent cash flow for 10 years. The Mark 3 arrangement does not offer a local group much of a share in profits, but it does get housing built in their community. If such a group gains expertise in the process, it could probably make a more favorable joint venture arrangement on its next project.

CONCLUSION

A community development corporation has some basic options when packaging a limited-dividend project under Section 236 of the National Housing Act. They involve the choice and structuring of a legal and financial relationship with a builder, co-developer, and investment banker. There is no formula which can be applied to the details of the kinds of relationships which can be structured and their financial implications, but the figures presented here are based on real cases. They reflect attitudes held by the financial community with reference to tax shelter investment in low-income housing. For instance, we found that when a community group brings in a builder as co-developer who has financial means and experience in housing, some investment bankers would usually be willing to place a higher investment value on the project than if the CDC acted as sole developer. Bringing in the builder as co-developer means you have to give him a greater share of the profits. In the case presented in the paper, this resulted in the

same profit to the CDC as when the CDC was acting as sole developer, because the total profit to be shared was greater.

Within certain value parameters discussed in the paper, the final terms of a deal which a CDC can structure is dependent on the needs and the negotiating skill of the parties involved.